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Commissioner	:	M. R. Peevey
Admin. Law Judge	:	R. A. Barnett
Witnesses	:	M. K. Bumgardner
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CALIFORNIA PUBLIC UTILITIES COMMISSION

ORA

Office of Ratepayer Advocates

Office of Ratepayer Advocates Report On the PG&E/CPUC Energy Division Staff Proposed Bankruptcy Settlement Agreement

REDACTED VERSION

San Francisco, California
August 29, 2003

OFFICE OF RATEPAYER ADVOCATES REPORT
ON THE PG&E/CPUC ENERGY DIVISION STAFF
PROPOSED BANKRUPTCY SETTLEMENT AGREEMENT
I. 02-04-026

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CHAPTER 1

SUMMARY OF ORA'S REPORT

(WITNESS: TRUMAN L. BURNS)

I. SUMMARY OF ORA'S REPORT

The Office of Ratepayer Advocates ("ORA") opposes the proposed Bankruptcy Settlement Agreement ("PSA") offered by Pacific Gas and Electric Company ("PG&E") and the CPUC Energy Division Staff. ORA supports the resolution of PG&E's bankruptcy proceeding through a settlement, but the terms of the PSA are not in the best interests of PG&E's ratepayers. In this and subsequent chapters, ORA explains its opposition to the PSA, and offers some potential modifications. ORA has had an extremely short time to conduct discovery and prepare testimony, and has received considerable opposition during discovery from both PG&E and the CPUC Energy Division staff.

A. Summary of Recommendations and Conclusions

Below is a summary of ORA's major recommendations and conclusions:

- ✓ The size of the Regulatory Asset has not been justified, and it results in substantial cash distributions to shareholders (Chapter ("Ch.") 5)
- ✓ The Regulatory Asset is very expensive, with ratepayers paying upwards of an 18% interest rate on the net undercollection. (Ch. 2) Capitalizing what normally would have been treated as an expense at the full cost of capital grossed up for taxes is the most expensive way possible to resolve PG&E's debt problem.
- ✓ The Regulatory Asset involves complex tax issues, and it is unclear that ratepayers are receiving sufficient tax value from tax refunds on PG&E's year 2000 net operating loss ("NOL") to compensate for the over $2 billion in taxes they will pay through the Regulatory Asset. (Ch. 7)

- ✓ The Regulatory Asset would be rendered unnecessary by merely extending current rates one more year (Ch. 4)
- ✓ Under the PSA, PG&E's debts will partially be paid off using available cash, generated through headroom and through shareholder's foregoing common stock dividends. ORA has been unable to conduct an adequate financial review of the cash balance, and at this point suspects it is understated by at least $700 million. (Ch. 8)
- ✓ The PG&E shareholder contribution to the PSA is very nebulous (Ch. 2); given the favorable impact of the PSA on PG&E's stock price. The PSA is virtually a complete ratepayer bailout using the most expensive ratemaking approach (a Regulatory Asset) possible. At a minimum, PG&E shareholders should be required to pay for all professional fees, including those incurred by the Commission. (Ch. 5)
- ✓ While PG&E alleges that this very expensive approach is necessary to achieve an investment grade credit rating, they have not proven this. (Ch. 3) Thus, the PSA is a very expensive plan that has no assurance of success.

In addition, the PSA has other problems:

- ✓ It impacts gas ratepayers who are not responsible for electricity related debts. (Ch. 5)
- ✓ It prejudges the outcome of the Annual Transition Cost Proceeding ("ATCP") Phase 2 proceeding (Application ("A.") 01-09-003) and prevents due process in that proceeding. (Ch. 5)
- ✓ The environmental proposal needs further clarification. (Ch. 6)
- ✓ It's not clear what ratepayers are getting for the "Clean Technology Commitment", if anything. (Ch. 6)

ORA recommends that the PSA at it stands be found unreasonable. To make it more reasonable, section 2 of the PSA should be changed by deleting all parts except for Section 2d, and inserting language that states the following:

- ✓ Current rates will be extended through the end of 2004. (Ch. 4)
- ✓ If a net undercollection remains in the Transition Cost Balancing Account ("TCBA") and Generation Asset Balancing Account (as reflected in the Decision ("D.") 01-03-082 accounting restatement) at the end of 2004 that exceeds $1 billion, it should be amortized through securitized bonds that are recovered through a dedicated rate component ("DRC") over 5 years. If

the net undercollection is less than $1 billion, the rate freeze should be extended long enough to allow complete recovery. (Ch. 4)

- ✓ The DRC shall not be grossed up for ratemaking taxes (Ch. 4)
- ✓ Section 2d of the PSA should be modified to replace all references to the Regulatory Asset with securitized bonds recovered through a DRC, and taxes deducted from refunds from generators and other energy suppliers should not exceed the tax value of tax refunds on year 2000 net operating loss (Ch. 5).

If the Commission chooses not to extend current rates for one more year, and chooses not to use securitized bonds and a DRC, ORA makes the following recommendations:

- ✓ There should be a financial review by auditors of all information relied upon in developing the PSA, including the projected $2.365 billion cash balance and 2003 headroom, and any discrepancies reflected in the size of the Regulatory Asset. (Ch. 8)
- ✓ Taxes for ratemaking purposes on the Regulatory Asset should be limited to the tax value ratepayers received from the tax year 2000 net operating loss. (Ch. 7)
- ✓ Section 2g of the PSA related to the Commission "facilitating and maintaining investment grade credit ratings for PG&E" should be deleted. (Ch. 3)

In addition, ORA makes the following recommendations:

- ✓ The PSA should be modified to say that PG&E's shareholders shall pay for all bankruptcy related costs including interest on debt which exceeds the interest rate applied to the TCBA and related accounts, and all professional fees incurred by both PG&E and the Commission. (Ch. 4 and 5)
- ✓ All language related to the ATCP Phase 2 proceeding in Section 9 of the PSA should be removed. (Ch. 5)
- ✓ Section 17 of the PSA, relating to the preservation and environmental enhancement of PG&E land, shall be clarified to meet the concerns addressed in Chapter 6 of ORA's testimony. (Ch. 6)
- ✓ Section 18 of the PSA, relating to "Clean Technology Commitment", shall be removed. (Ch. 6)

CHAPTER 2

RATE ISSUES

(WITNESS: L. JAN REID)

I. SUMMARY AND RECOMMENDATIONS

The purpose of this chapter is to address the rate issues related to the PSA between PG&E and the Energy Division of the California Public Utilities Commission.

The PSA would allow PG&E to repay past debts with current and future rates. The PSA claims that PG&E and PG&E Corp.'s shareholders have foregone dividends of $1.7 billion and stipulates that:

- ✓ A regulatory asset of $2.21 billion will be established for a 9-year period. The regulatory asset will be part of PG&E's rate base.
- ✓ PG&E's return on equity ("ROE") shall be no less than 11.22% per year until it receives an S&P credit rating of A– or a Moody's credit rating of A3.[1]
- ✓ Once PG&E's actual capital structure reaches 52% common equity, PG&E's authorized capital structure will be no less than 52% common equity for the life of the regulatory asset.[2]
- ✓ PG&E agrees not to pay dividends to common or preferred shareholders before July 1, 2004.
- ✓ 80% of all aggregate fees and commissions related to the financing of the PSA will be paid in equal shares to Lehman Brothers and UBS Warburg.

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1 PSA, p. 14. This issue is discussed in Chapter 1.

2 For 2004 and 2005, the greater of the Forecast Average Equity Ratio or 48.6% will be used.

- ✓ PG&E will be allowed to recover all costs associated with Phase 2 of its Annual Transition Cost Proceeding Application ("ATCP") as filed in A.01-09-003.[3]

- ✓ The PSA will not commence until PG&E receives investment grade credit ratings of at least BBB– from Standard and Poor's and Baa3 from Moody's.

ORA reviewed appropriate utility filings, SEC filings of PG&E Corp., and past Commission decisions. Based on our review, ORA finds that:

1. PG&E's ratepayers will have paid $10.08-$10.18 billion of PG&E's debt by the end of the 9-year period stipulated by the PSA in order to resolve a $4.035 billion problem, which is equivalent to paying an effective interest rate of 17.95-18.20 percent per annum.

2. PG&E already has an authorized ROE that is higher than the median ROE of BBB-rated electric utilities and an authorized capital structure that has more equity than the median of BBB-rated electric utilities.

3. PG&E common stockholders will forego dividend payments of approximately $493 million under the PSA in addition to the $1.234 billion of dividends that have already been foregone since the fourth quarter of 2000.

4. PG&E's common stockholders have seen an increase in market value of over $1.4 billion since the PSA was announced, due to the increase in share price of PG&E common stock. This increase in share value has offset much of the foregone dividend loss.

5. Former CPUC President Lynch has stated that PG&E made a business decision to go to bankruptcy court rather than seek a negotiated solution to the energy crisis.

6. If the California Pollution Control Financing Authority does not allow PG&E to reinstate its Pollution Control Bonds, the PSA will have to be changed to reflect the increased interest cost of refinancing these bonds as taxable bonds rather than tax-exempt bonds.

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[3] PSA, p. 17.

II. WHO PAYS PG&E'S DEBT?

The PSA would allow PG&E to pay off a total of $12.136 billion[4] of PG&E's debt. Of this amount, $2.365 billion comes from cash-on-hand, $2.795 billion is reinstated preferred equity and debt, $500 million is short-term debt, and $7.683 billion is new long-term debt. The discussion below shows that the ratepayers will pay substantially more than what PG&E's shareholders will pay under the PSA. The contribution of PG&E shareholders is discussed in Section III below, and must be viewed in the light of the increase in PG&E's stock price since the PSA was announced.

B. Ratepayer Costs

The large balance of cash-on-hand is predominantly due to the fact that PG&E's ratepayers have been burdened with significant rate increases since the beginning of 2001. On January 4, 2001 the CPUC raised rates temporarily by one-cent per kwh.[5] On March 27, 2001 the Commission raised rates by an additional three-cents/kwh and converted the temporary increase into a permanent increase[6]. Because the 3-cent increase was not implemented in rates until May 2001, the PUC adopted an additional half-cent "catch-up" surcharge in D.01-05-064, which remains in effect today. However, the rate increases authorized in D.01-01-018 and D.01-03-082 were intended to pay future procurement costs, not past debts.[7]

ORA calculates the total cost of the regulatory asset in the workpapers to Chapter 8. As shown in Table 2-1, PG&E's ratepayers will have paid from $10.08

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4 PG&E Testimony, p. 8-4.

5 D.01-01-018.

6 D.01-03-082, p. 2.

7 D.01-03-082, COL 13 and D.01-01-018, OP 2.

billion to $10.18 billion, which is much greater than the total wholesale power cost undercollection.

Table 2-1

Total Ratepayer Costs under the Proposed Settlement Agreement

Item	**Amount ($ billion)**
2001-2002 Headroom	3.894
2003 Headroom	0.775-0.875
Cost of Regulatory Asset	5.412
Total	**10.080-10.180**

At the end of 2000, procurement related obligation were under-collected by $4.035 billion.[8] ORA treated the $4.035 billion undercollection as a loan with a term of 12 years (3 years between 2000 and 2003 plus the 9-year term of the PSA) and found that the effective interest rate is 17.95-18.20 percent per annum.

C. Net Present Value ("NPV")

As mentioned previously, ORA calculates that PG&E's ratepayers will have paid from $10.08 billion to $10.18 billion if the Commission adopts the PSA. ORA calculates that the net present value of ratepayer contributions is $9.212-$9.312 billion using a discount rate equal to the yield of the 10-year note and

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8 This information has been provided to me by ORA witness Chris Danforth. It is my understanding that this figure was calculated by summing all of the over collections and undercollections shown in the various regulatory accounts reported in PG&E's December, 2000 Transition Cost Balancing Account report.

$8.618-$8.718 billion using a 9% discount rate.[9] I calculated NPV using a starting point of December 31, 2003, and used the actual headroom for 2001 and 2002 in its calculations. Energy Division witness Paul Clanon estimates that the NPV of ratepayer costs is $3.154 billion and that the total ratepayer cost is $7.129-$7.229 billion. The differences between Clanon's analysis and ORA's are given in Table 2-2.

Table 2-2:

NPV Methodology

Item	ORA	Paul Clanon
Discount Rate	4.43%	9.00%
Data Source for Headroom	PG&E's regulatory filings as adjusted to account for the Revenue Reduction Bonds (see Chapter 8 workpapers)	PG&E's SEC 8-K filing
2001 and 2002 Headroom	Adjusted headroom from the year incurred to 12/31/2003. ORA made this adjustment by multiplying 2001 headroom by $(1 + \text{the discount rate})^2$ and 2002 headroom by (1 + the discount rate).	No adjustment

NPV calculations are always highly sensitive to the discount rate chosen. The discount rate should be indicative of the actual value of future payments in today's dollars. If both the Commission and the Bankruptcy Court approve the PSA, there will be an extremely high level of certainty that ratepayers will pay the costs associated with the PSA. Thus, it can be argued that the discount rate should reflect the return that ratepayers can obtain from risk-free investments over the life of the analysis. Since the PSA has a 9-year life, the ORA used the current yield of the 10-year note as a discount rate. Higher discount rates have been used in other

9 On August 28, the yield of the 10-year U.S. Treasury Note was 4.43%. Energy Division witness Paul Clanon used a discount rate of 9.00% in his analysis.

applications before the Commission, such as in energy efficiency programs, where future benefits associated with energy savings are more uncertain.

III. DIVIDENDS

The PSA states that "PG&E's and PG&E Corporations shareholders have foregone and will forego dividends of approximately $1.7 billion."[10] The PSA would prohibit PG&E from paying dividends before July 1, 2004. As of July 15, 2003, there were 411,422,603 shares of PG&E Corporation common stock outstanding.[11]

PG&E reduced its quarterly dividend from 49 cents/share to 30 cents/share in December 1996. It continued paying a quarterly dividend of 30 cents/share through the 3rd quarter of 2000. If PG&E does not pay a dividend until after July 1, 2004, its shareholders will have foregone total dividend payments of $1,727,974,932.60 (assuming that 411,422,603 shares were outstanding through the entire period). PG&E Corp.'s apparent policy was to announce a dividend payment on the 13th day of the last month in each quarter and pay the dividend on the 15th day of the following month. If PG&E continued their previous dividend policy, the PSA would allow PG&E to pay common stock dividends for the 2nd quarter of 2004 on July 15, 2004.

The legal remedies PG&E used to address its outstanding debt may affect the magnitude of the foregone dividends. PG&E sought the protection of the Bankruptcy Court on April 6, 2001. On that same day, CPUC President Lynch commented that:

> Today PG&E made a business decision to cut off serious negotiations to resolve the electricity crisis and instead sought formal bankruptcy protection. PG&E, as of April 4, 2001, possessed $2.3 billion in cash. It clearly chose to go to court rather than continue to seek a negotiated solution to the issues California faces. ("Statement of CPUC President

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10 PSA, p. 2.

11 PG&E response to ORA data request 2, question 5.

Loretta Lynch Regarding PG&E's Bankruptcy Filing," *CPUC News Release*, April 6, 2001)

Less than six months later (October 2, 2001), SCE and the CPUC entered into a Settlement Agreement that resulted in the payment of SCE's procurement obligations as of July 31, 2003. Edison International recently announced that its board of directors "will probably declare reinstatement of the common stock dividend at its Dec. 11 meeting, with the first payment to shareholders likely to follow in early 2004."[12]

It is clear that PG&E could have negotiated an agreement with the Commission similar to the SCE/CPUC agreement. In that case, PG&E might have been able to resume paying dividends to its common stock shareholders at an earlier date.

The PSA requires that PG&E shareholders not receive dividend payments until the 2^{nd} quarter of 2004. Since the PSA was announced on June 19, 2003; it only requires PG&E to forego the payment of dividends for four additional quarters (2nd quarter 2003 through 1^{st} quarter 2004). Assuming a dividend payment on common stock of 30 cents/share and 411,422,603 shares outstanding, the PSA requires PG&E common stockholders to forego dividend payments of $493,707,123.60. However, PG&E shareholders have lost another $68 million due to the failure of PG&E Corp. to pay its common stock shareholders all of the dividend payments that were received from the utility from 1997-1999. (See Table 2-3)

PG&E shareholders have already received three times as many benefits since the announcement of the PSA than they will lose by foregoing the future dividend payments mandated by the PSA. The daily closing share price of PG&E stock has risen from $18.50 on June 19 to $21.93 on August 28. This amounts to a total gain to common shareholders of $1,411,179,528.29 compared to PSA-mandated foregone dividend payments of less than $494 million.

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[12] "Edison To Pay Preferred Securities Before Reinstating Div", Dow Jones Business News, David Bogoslaw, http://www.biz.yahoo.com/djus/030822/1432000488_1.html

PG&E shareholders have also benefited by the fact that ratepayers paid all of the dividends for the holding company from 1997 to 2000. On January 10, 2002, California Attorney General Bill Lockyer file suit against PG&E and "charged Pacific Gas & Electric Corporation with illegal, unfair and fraudulent business practices that drove its California utility subsidiary into bankruptcy and breached legal agreements with the state to protect California ratepayers".[13]

A news release issued from the Attorney General's office that day stated that:

> From 1997 through the summer of 2000, PG&E provided over $4.6 billion in cash to PG&E Corp. in the form of $1.76 billion in shareholder dividends and repurchases of PG&E common stock, representing 60 percent of the cash inflow to the utility's parent corporation for this period. Even as the California utility sank into financial difficulties, PG&E Corp. continued to collect payments from the utility without infusing needed capital.

Table 2-3 provides a year-by-year comparison of the common stock dividend payments made by the utility and the actual common stock dividend payments that PG&E Corp.'s shareholders received. From 1997-1999, the utility made dividend payments of $1.53 billion. However, PG&E common stock shareholders only received $1.462 billion of this money.

Table 2-3:

Dividend Payments in Millions of Dollars

Item	**1997**	**1998**	**1999**	**Total**
Utility Dividend Payments	699	416	415	1,530
Holding Company payments to PG&E Corp. shareholders	527	470	465	1,462
Excess Utility payments	172	–54	–50	68

Note: All data is taken from the Attorney General's January 10, 2002 news release.

13 http://caag.state.ca.us/newsalerts/2002/02-003.htm

IV. FORECAST OF RATE INCREASES

In Section II, I give the level of ratepayer payments over the next nine years under the PSA. Ratepayers might incur other losses as well. These losses arise from the fact that the PSA stipulates that:

- ✓ PG&E's authorized capital structure is projected to increase from 48.00% common equity currently to 48.60% in 2004, 50.50% in 2005, and 52% after 2005.[14] Since the cost of common equity is almost always higher than the cost of debt and cost of preferred stock, ratepayer costs will increase relative to current levels.
- ✓ Despite the fact that interest rates are at an all-time low, PG&E'S return on equity ("ROE") will remain at a minimum of 11.22% until PG&E receives either an A– rating from S&P or a rating of A3 from Moody's. This means that ratepayers will continue to pay PG&E an above market ROE on PG&E's entire non-transmission rate base, not just its electric rate base.

PG&E's authorized ROE and capital structure are already significantly above the median level of BBB-rated electric utilities as reported by S&P.[15] The median ROE of BBB-rated electric utilities was 10.90% compared to PG&E's 11.22%. PG&E also has an authorized capital structure that has much more equity than the median BBB-rated electric utility. PG&E has an authorized capital structure of 48.00% common equity, 46.80% debt, and 5.80% preferred equity. The median capital structure for BBB-rated electric utilities is 39.60% common equity, 58.78% debt, and 2.70% preferred equity.

V. POLLUTION CONTROL BONDS

PG&E expects to reinstate approximately $1.7 billion[16] in Pollution Control Refunding Revenue Bonds (Pacific Gas and Electric) that were issued by the California

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[14] PG&E Testimony, p. 8-15.

[15] Standard and Poor's Corporate Ratings Criteria, p. 54.

[16] PG&E Testimony, p. 8-4.

Pollution Control Financing Authority ("CPCFA").[17] These bonds are tax-exempt and carry a low rate of interest. PG&E has not yet received CPCFA approval to modify the terms of the bond documents to ensure that all of these CPCFA bonds can be reinstated.[18]

If the CPCFA does not allow PG&E to reinstate the bonds at a tax-exempt rate, the bonds may have to be refinanced at much higher interest rates. PG&E has estimated that refinancing these bonds at non tax-exempt rates will result in additional interest payments of $23 million per year for the next 20 years. The PSA, the CPUC Plan of Reorganization Plan, and PG&E's Plan of Reorganization all assume that PG&E's Pollution Control Bonds will be reinstated.

This issue may be resolved at the next CPCFA meeting scheduled for September 30. ORA has been working with PG&E in an attempt to convince the CPCFA that it should allow PG&E to reinstate the bonds and that reinstatement would be in the best interest of PG&E's ratepayers.

However, it is by no means certain that the CPCFA will allow PG&E to reinstate the PCBs. If PG&E does not receive CPCFA approval, the PSA may have to be changed to account for the effect of financing the PCBs at higher interest rates.

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[17] PSA, Sections 1a-1d and 1dd.

[18] PG&E Testimony, p. 8-5.

CHAPTER 3

CREDIT AND HEDGING ISSUES

(WITNESS: L. JAN REID)

I. SUMMARY AND RECOMMENDATIONS

The purpose of this chapter is to address the credit and hedging issues related to the PSA between PG&E and the Energy Division of the California Public Utilities Commission. The PSA will not commence[19] unless PG&E receives investment grade credit ratings from both S&P and Moody's.[20] The PSA stipulates that the Commission shall "act to facilitate and maintain investment grade credit ratings for PG&E."[21]

PG&E provides a comparison of S&P credit ratings with financial ratios and business profiles and implies that the PSA will achieve an investment grade credit rating. ORA reviewed appropriate utility filings, rating agency documents, and has had several discussions with S&P and Moody's concerning PG&E's credit rating. Based on our review, ORA finds that:

1. The Commission should not adopt a policy of maintaining an investment grade credit rating for PG&E. Therefore, Section 2g of the PSA should be deleted. Instead, the Commission should continue its tradition of considering a wide variety of factors when making decisions on utility applications. These considerations have typically included

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[19] PSA, Section 16a.

[20] The PSA defines an investment grade credit rating as a rating of at least BBB– from S&P and at least Baa3 from Moody's. (PSA, Section 1z)

[21] PSA, Section 2g.

credit ratings,[22] collateral requirements, environmental considerations, ratepayer equity, general economic conditions, and other factors.

2. PG&E has received no assurance from S&P and Moody's that Commission enactment of the PSA will result in an investment grade credit rating.[23]

3. As of July 25, 2003, S&P had not analyzed the PSA.

4. PG&E does not know when (if ever) it will receive an A– credit rating from S&P.[24]

5. Only eight utilities have an S&P rating of BBB, BBB–, or BBB+ and a business profile of 7. PG&E witness Murphy partially bases his analysis on this small sample size.

6. Although credit rating agencies consider quantitative data when assigning ratings, the most important part of the rating process is the agency's judgment of the future credit risk of the company being rated.

II. CREDIT ISSUES

This section addresses credit issues related to Commission policy, the credit ratings process, and overall rates of return and capital structure of regulated utilities. ORA urges the Commission to delete Section 2g of the PSA, recognize that credit ratings are assigned based on the judgment of the rating agency, and not assume a direct linkage between the future credit rating of PG&E and its projected financial ratios under the PSA.

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[22] ORA does not agree that credit ratings should be considered when the Commission sets a utility's rate of return in a GRC or cost-of-capital proceeding.

[23] PG&E response to ORA data request 2, question 2.

[24] PG&E response to ORA data request 5, question 2.

A. Commission Policy

Section 2g of the PSA states that:

> The Commission recognizes that the establishment, maintenance and improvement of Investment Grade company credit ratings is vital for PG&E to be able to continue to provide safe and reliable service to its customers. The Commission further recognizes that the establishment, maintenance and improvement of PG&E's Investment Grade company credit ratings directly benefits PG&E's ratepayers by reducing PG&E's immediate and future borrowing costs, which, in turn, will allow PG&E to finance its operations and make capital expenditures on its distribution, transmission, and generation assets at lower cost to its ratepayers. In furtherance of these objectives, the Commission agrees to act to facilitate and maintain Investment Grade company credit ratings for PG&E.

The Commission should not adopt a policy of providing additional ratepayer funds in order to facilitate and maintain investment grade credit ratings for PG&E or for any other regulated utility. If the Commission adopts such a policy here, all utilities will argue that the Commission must provide the utility with ever increasing rates of return and other considerations in order to satisfy this Commission policy. Such a policy will effectively limit Commission authority and restrict its ability to adapt to changing economic, political, and cultural conditions, and will greatly and unnecessarily burden ratepayers.

Instead, the Commission should continue its tradition of considering a wide variety of factors when making decisions on utility applications. These considerations have typically included credit ratings,[25] collateral

[25] ORA does not agree that credit ratings should be considered when the Commission sets a utility's rate of return in a GRC or cost-of-capital proceeding.

requirements, environmental considerations, ratepayer equity, general economic conditions, and other factors.

In R.01-10-024, both PG&E and Southern California Edison have argued that the Commission should approve its procurement plans. They have based their arguments in part on the affect a certain Commission policy might have on the utility's credit ratings. These arguments have included:

- ✓ PG&E states that it will not be able to enter into any longer term contracts until it exits bankruptcy and has an investment grade credit rating.[26]
- ✓ PG&E asks the Commission to "sustain or increase the utility's credit capacity by increasing the authorized rate of return."[27]
- ✓ SCE's credit rating will cause its equity costs to increase.[28]
- ✓ More equity will need to be added to SCE's capital structure if additional power contracts are signed.[29]
- ✓ The Commission should assure the credit rating agencies that **all** direct and indirect procurement costs will be recovered.[30] SCE's statement implies that it believes that all procurement costs should be declared to be reasonable before they are actually incurred.
- ✓ The Commission must not assign DWR contracts to the utilities.[31]

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26 PG&E Long Term Plan, p. 1-13.

27 *Ibid.*, p. 1-15.

28 SCE Long Term Plan, p. 20.

29 *Ibid.*, p. 21, lines 9-11.

30 *Ibid.*, p. 23, lines 12-15

31 *Ibid.*, pp. 15-16.

- ✓ The Commission must take actions to ensure a stable customer base by limiting the ability of customers to switch between bundled service and direct access.[32]

- ✓ SCE implies that its credit rating will be upgraded to investment grade if the Commission takes a series of actions.[33] The "required" actions include: recognizing that collateral requirements are a cost associated with power contracting, recognizing the off-balance sheet debt equivalence of long-term contracts, clarifying that DWR contracts will never be assigned to SCE.

It is clear from the past statements of PG&E and SCE that if the Commission adopts a policy of "facilitating and maintaining investment grade credit ratings for PG&E", other utilities will request higher rates of return and other considerations and will use the Commission policy as justification for their request. For these and other reasons discussed above, Section 2g of the PSA should be deleted.

B. PG&E's Credit Rating Witnesses

Moody's Investment Service has stated (see Section IIC) that:

> "Moody's ratings are not based on a defined set of financial ratios or rigid computer models. Rather, they are the product of a comprehensive analysis of each individual issue and issuer by experienced, well-informed, impartial credit analysts."

S&P has explained (see Section IIC) that "There are no formulae for combining scores to arrive at a rating conclusion."

Nevertheless, PG&E is sponsoring "credit ratings" testimony from two witnesses: Paul Murphy and Steven Fetter. Murphy claims that the material provided in Exhibit A of his testimony is from an S&P report

32 *Ibid.*, pps. 9 and 25.

33 *Ibid.*, p. 4.

published in 2002. PG&E has been unable to produce such a report and ORA finds no such report on S&P's website. In response to an ORA data request, PG&E faxed ORA a copy of a S&P report published on June 23, 2000. S&P published a report entitled "Summary Financial Ratios for Electric Utilities" on July 7, 2000 that uses 1999 data. It is ORA's belief that the material provided by witness Murphy in Exhibit A of Chapter 7 uses 1999 data.

Murphy provides a comparison of S&P credit ratings with financial ratios and business profiles and implies that the PSA will achieve an investment grade credit rating. This is partially contradicted by PG&E witness Fetter who claims that "Since the early 1990s, all three rating agencies have elevated qualitative factors to almost equal status."[34]

Murphy believes that PG&E's business profile will be a 7.[35] The business profile analysis provided by witness Murphy is based on a grand total of eight companies.[36] This is hardly a large enough sample to draw definitive conclusions.

Out of 313 utilities rated by S&P, only eight companies had credit ratings in the BBB category (BBB, BBB+, and BBB–) and a business profile of 7. Summary data concerning these companies is given in Table 3-1.

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[34] PG&E Testimony, p. 6-4, l. 10-11. ORA does not agree that qualitative factors have been elevated to almost equal status by all three rating agencies. As explained in Section IIC, both S&P and Moody's place greater reliance on qualitative factors when making credit rating determinations.

[35] PG&E Testimony, p. 7-11.

[36] Source: Standard and Poor's Ratings Direct, July 10, 2003.

Table 3-1

Business Profiles of BBB rated Electric and Gas Utilities

Company	**S&P Rating**	**Business Profile**
AEP Resources	BBB	7
Black Hills Corp.	BBB–	7
Entergy Mississippi, Inc.	BBB	7
Entergy New Orleans, Inc.	BBB	7
Green Mountain Power	BBB–	7
Market Hub Partners Storage	BBB+	7
Potomac Capital Investment	BBB	7
System Energy Resources	BBB–	7

The business profile assigned by S&P is a measure of business risk. Although it is a subjective assessment, it does not include all of the qualitative factors accounted for by S&P prior to reaching a ratings decision. As I have explained above, ratings decisions are primarily a matter of the judgment of the ratings agency.

Fetter also implies that PG&E will not receive an investment grade credit rating unless the CPUC fully supports the PSA. He refers to an S&P document (see Attachment 3A) published on June 26 and claimed that "S&P reacted to announcement of the Settlement Plan by expressing continuing reservations about possible impacts on PG&E's credit quality as a result of less than full support for the Settlement Plan by the CPUC."[37]

[37] PG&E Testimony, p. 6-11, lines 16-19.

S&P actually said that "a cloud will likely hang over the prospects for improved credit quality at California's utilities until the state implements alternative solutions that are consistent with sound credit quality." ORA has provided several alternative solutions (see Chapter 5) that we believe might be consistent with sound credit quality.

PG&E witness Murphy also misrepresents the content of S&P documents in his testimony. Murphy refers to an S&P document (see Attachment 3A) published on June 26, 2003 and claims that "S&P warns that actions which frustrate the compromise plan would impact PG&E's ability to achieve sound financial results."[38]

In fact S&P does not issue a warning. It poses a question. S&P actually stated that:

> The potential disparity between SCE and PG&E rates caused the governor and commissioners to express their dissatisfaction with the proposed CPUC/PG&E settlement. Consequently, the question remains whether the projected disparities between the utilities' rates will have political implications that might frustrate the compromise plan and PG&E's ability to achieve sound financial results.

S&P has not taken a position on the PSA. In fact, as of July 24 of this year, S&P had not performed a financial analysis of the PSA. At that time, S&P stated that "analysis of the proposal financial projections must still be performed."[39] (See Attachment 3A)

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[38] PG&E Testimony, p. 7-22, lines 7-9.

[39] "Credit Quality for U.S. Utilities Continues Negative Trend", Ratings Direct, Barbara A. Eiseman, July 24, 2003.

C. The Ratings Process

The determination of credit ratings is primarily based on the judgment of the rating agency. It is not a simple procedure and is not based solely on quantitative factors or business profiles. In fact, qualitative factors carry more weight in the process than quantitative factors. Standard and Poor's ("S&P") considers general factors such as industry characteristics, competitive position, marketing, technology, efficiency, regulation, financial characteristics, financial policy, profitability, capital structure, cash flow protection, and financial flexibility.[40] Moody's considers all "relevant risk factors and viewpoints."

S&P has explained that:[41]

> "There are no formulae for combining scores to arrive at a rating conclusion. Bear in mind that ratings represent an art as much as a science. A rating is, in the end, an opinion. Indeed, it is critical to understand that the rating process is not limited to the examination of various financial measures. Proper assessment of debt protection levels requires a broader framework, involving a thorough review of business fundamentals, including judgments about the company's competitive position and evaluation of management and its strategies. Clearly, such judgments are highly subjective; indeed, subjectivity is at the heart of every rating."

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[40] Standard and Poor's Corporate Ratings Criteria, p. 17.

[41] *Ibid.*

The ratings process at Moody's is even more oriented toward qualitative factors than is the process at S&P. Moody's has explained that:[42]

> Because it involves a look into the future, credit rating is by nature subjective. Moreover, because long-term credit judgments involve so many factors unique to particular industries, issuers, and countries, we believe that any attempt to reduce credit rating to a formulaic methodology would be misleading and would lead to serious mistakes.
>
> That is why Moody's uses a multidisciplinary or "universal" approach to risk analysis, which aims to bring an understanding of *all* relevant risk factors and viewpoints to every rating analysis. We then rely on the judgment of a diverse group of credit risk professionals to weigh those factors in light of a variety of plausible scenarios for the issuer and thus come to a conclusion on what the rating should be. Several analytical principles guide that reasoning process.
>
> . . . Moody's ratings are not based on a defined set of financial ratios or rigid computer models. Rather, they are the product of a comprehensive analysis of each individual issue and issuer by experienced, well-informed, impartial credit analysts.

D. Financial Ratios

S&P makes use of two general types of quantitative analysis: ratio medians and ratio guidelines. PG&E witness Murphy provides an example of ratio guidelines in Chapter 7, Exhibit A, page 1. Ratio medians are simply the median financial ratio (e.g., pre-tax interest coverage) for all firms in a particular rating category. Ratio medians measure financial risk

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[42] Source: http://www.moodys.com/moodys/cust/staticcontent/2000200000265776.asp?section=about&topic=rapproach

while ratio guidelines incorporate financial risk and business risk. S&P explains that:

> Strengths and weaknesses in different areas have to be balanced and qualitative factors evaluated. There are many nonnumeric distinguishing characteristics that determine a company's creditworthiness.[43]

> Guidelines are not meant to be precise. Rather, they are intended to convey ranges that characterize levels of credit quality as represented by the ratings categories.[44]

In a sense, the analysis presented by PG&E witness Murphy represents an *ex-post* analysis of S&P credit ratings. It is essentially an analysis of the current relationship between financial ratios, business profiles, and credit ratings. It is apparently not used by Moody's and is certainly not even a guarantee of future S&P ratings.

This is not to say that financial ratios are unimportant or that S&P does not consider them when assigning credit ratings. Financial ratios and business profiles are a part of the decision making process at S&P, but only a part.

III. HEDGING COSTS

Section 12 of the PSA states that "the actual reasonable cost of PG&E's interest rate hedging activities with respect to the financing necessary for the Settlement Plan shall be reflected and recoverable in PG&E's retail gas and electric rates without further review." The PSA does not state how the

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[43] Standard and Poor's Corporate Ratings Criteria, p. 53.

[44] *op. cit.*, p. 56.

Commission will determine whether or not the hedging costs are reasonable since the PSA prevents further review of these costs.

On July 25, PG&E filed a petition to modify D.02-11-030 in which PG&E asked for the Commission to allow it to engage in additional interest rate hedges. On August 22, a draft decision ("DD") was issued by ALJ Long granting PG&E some of the authority it sought. The DD deferred recovery of the costs for interest rate hedges to "the post-bankruptcy true-up ordered in D.02-11-027 in A.02-05-022."[45]

In its response to PG&E's petition, ORA recommended that a Financial Hedging Review Group ("FHRG") be formed to evaluate PG&E's interest rate hedges before they are executed.[46] The DD disagreed with ORA and established a process whereby PG&E could only engage in interest rate hedges if they were approved by the Commission's Financing Team.[47] UBS Warburg is a member of the Commission's Financing Team.

There is an obvious conflict between the DD and the PSA since the DD would determine the reasonableness of PG&E's interest rate hedges in A.02-05-022 and the PSA would declare the hedges to be *per se* reasonable.

The PSA also mandates that "PG&E agrees to name UBS Warburg LLC and Lehman Brothers as exclusive book runners, lead managers and hedging providers of all financings pursuant to the Settlement Plan with equal economics for 80 percent of the aggregate of total fees and commissions payable on such

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[45] DD, COL 4.

[46] The ORA proposed that membership in the FHRG be limited to representatives of ORA, Energy Division, TURN, PG&E, and UBS Warburg.

[47] DD, OP 2.

financings, and otherwise on customary terms as agreed among them."[48] Thus, UBS Warburg is in the position of both approving PG&E's hedges and profiting from the execution of these hedges. This is an obvious conflict of interest.

If the Commission does not modify the DD and does not establish a FHRG as suggested by the ORA then; Section 12 of the PSA should be deleted, the reasonableness of PG&E's interest rate hedges should be determined in A.02-05-022, and UBS Warburg should not be allowed to both approve interest rate hedges and participate in the execution of those hedges.

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[48] PSA, Section 13d.

ATTACHMENT 3A — ANALYST REPORTS

California Utilities: Another Step Forward?

Analyst:

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Publication date: 26-Jun-03, 15:17:59 EST
Reprinted from Ratings Direct

There appear to be signs of life for California's investor-owned utilities. As always, there are also mixed signals. After months of discussion, the California Public Utilities Commission's ("CPUC") staff and Pacific Gas & Electric Co. (PG&E; D/--/D) have hammered out a compromise reorganization plan for the emergence of PG&E from bankruptcy. Under the compromise plan, PG&E would remain an integrated company that continues to own and operate electric and gas transmission and distribution assets and electric generation. The staff must present the settlement agreement to the commissioners for their approval, an approval that is not guaranteed. Two of the CPUC's five commissioners and Governor Gray Davis quickly criticized the level of retail electric rates assumed in furtherance of the compromise plan's objectives. Although PG&E's creditors must be polled to obtain their consent to the compromise reorganization plan, the parties are confident that the assent of the creditors will be obtained.

Although Standard & Poor's Ratings Services is waiting to receive financial projections that illustrate the terms of the compromise plan, the fact that the parties have stated in the proposed agreement that they have strived to produce a reorganization plan that will yield an integrated utility that exhibits investment-grade credit attributes appears to be a positive development for credit quality.

PG&E is not alone in seeing hints of light at the end of the tunnel. Southern California Edison Co. ("SCE"; BB/Developing/--) has benefited from its own settlement agreement reached with the CPUC. The settlement permits SCE to recover past operating shortfalls through its PROACT account, which should be fully accomplished in the near future.

The issue that Standard & Poor's must now address is whether the utilities are on an upward trajectory, and, if so, will prospects for improved credit quality continue.

Beyond the two settlements, there is additional evidence of a changing environment that is more supportive of sound credit quality for California's investor-owned utilities. By enacting Assembly Bill 57, California's legislature has directed the CPUC to provide the utilities with prospective reasonableness reviews of procurement activities in an effort to quash after-the-fact disallowances of procurement expenses. The legislation also directs the CPUC to provide timely cost recovery to facilitate the achievement of investment-grade ratings. Pursuant to Bill 57, the CPUC is conducting procurement proceedings for the state's principal investor-owned utilities.

Although Bill 57's enactment is a positive development, the legislation does not provide a panacea for the utilities' ills. For instance, the legislation shifted to the utilities, from California's Department of Water Resources (“CDWR”), financial responsibility for power purchases that need to be made to supplement the utilities' retained generation, existing bilateral contracts, qualifying facility contracts, and power from CDWR contracts used to meet customer demand.

In response to the financial hardships the utilities faced in 2000 and 2001, Bill 57 compels the CPUC to adjust electric rates if undercollections resulting from power-procurement activities exceed 5% of the prior year's procurement expenses. Yet the benefits of this 5% cap could be diluted by the scheduled expiration at the end of 2005. Thereafter, the CPUC will be vested with discretion to assess the time frame for implementing rate adjustments to address any shortfalls caused by expenses that outpace revenues. The sunset provision leaves unanswered the question of whether the CPUC, in a future exercise of its discretion, might permit a recurrence of the delayed rate relief that eviscerated the utilities' financial profiles in 2000 and 2001.

On balance, progress is being made. Yet some significant issues remain, including whether the full commission will adopt the compromise plan that its staff negotiated with

PG&E. Some additional challenges that are important to credit quality and that are expected to be resolved or clarified in coming months include:

Issues raised by The Utility Reform Network's ("TURN") legal challenge to the settlement agreement that SCE reached with the CPUC. Standard & Poor's is less concerned with the procedural elements of TURN's appeal than it is with the question of whether SCE is barred by Assembly Bill 1890 from retaining the headroom collected over the past two years to extinguish liabilities associated with the mismatch between revenues and expenses in 2000 and 2001. California's Supreme Court is expected to address the TURN appeal by the end of this summer. The resolution of the appeal might also have implications for PG&E, which has also accumulated large cash balances. The comprise plan for the reorganization of PG&E contemplates that upon emergence from bankruptcy, the cash balances will be applied to extinguish historical obligations created by power-procurement expenses that eclipsed revenues.

General rate cases are pending for SCE and PG&E. The outcome of these rate cases will serve as a barometer of the CPUC's commitment to long-term sound credit quality for the state's investor-owned utilities.

Financial responsibility for the CDWR contracts. Currently, the investor-owned utilities have operational responsibility for these contracts, but do not bear financial responsibility for them. The assignment of financial responsibility for these contracts to the utilities would likely result in Standard & Poor's imputation of debt-like fixed obligations to the utilities, which could erode their financial and credit profiles. PG&E and the CPUC have sought to address this issue in the compromise plan by creating preconditions to the assignment of financial responsibility for the contracts. The preconditions are aimed at preserving credit quality.

Disparities between the extent of rate reductions at SCE and PG&E. PG&E's settlement agreement with the CPUC contemplates modest rate reductions. Current rates will largely remain unchanged at PG&E for some time. By comparison, SCE has proposed to reduce consumer rates between 8% and 19% as part of its rate case and to reflect, among other things, the end of PROACT account collections. The potential disparity between SCE and PG&E rates caused the governor and commissioners to express their dissatisfaction with the proposed CPUC/PG&E settlement. Consequently, the question remains whether the projected disparities between the utilities' rates will have political implications that might frustrate the compromise plan and PG&E's ability to achieve sound financial results.

Governor Davis' quick criticism of the proposed CPUC-PG&E settlement underscores the strong political influences that remain a factor in California's management of its energy sector. If, after months of negotiations, the CPUC/PG&E settlement is frustrated by political considerations, a cloud will likely hang over the prospects for improved credit quality at California's utilities until the state implements alternative solutions that are consistent with sound credit quality.

Credit Quality for U.S. Utilities Continues Negative Trend

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Reprinted from Ratings Direct

Developments in California

After months of discussion, the staff of the California Public Utilities Commission (CPUC) and Pacific Gas & Electric Co. (PG&E) have hammered out a compromise reorganization plan for the emergence of PG&E from bankruptcy. Under the plan, PG&E would remain a vertically integrated utility, in sharp contrast to the utility's own plan. It would continue to own and operate electric and gas transmission and distribution assets and electric generation. Without hesitation, two of the CPUC's five commissioners, as well as Gov. Gray Davis himself, condemned the plan as untenable because the level of retail electric rates assumed would not be sufficiently reduced. If the PG&E settlement is frustrated by political considerations, a cloud will likely hang over the prospects for improved credit quality at California's utilities until the state implements alternative solutions that are consistent with sound credit quality. Nevertheless, the parties are confident that the assent of the creditors will be obtained. Standard & Poor's considers the fact that the parties have produced a reorganization plan that will yield an integrated utility exhibiting investment-grade credit attributes as a positive development. However, analysis of the proposal's financial projections must still be performed.

PG&E now joins Southern California Edison Co. (SCE) in perhaps seeing a glimmer of light at the end of a long, dark tunnel. SCE has benefited from its own settlement agreement with the CPUC, which has permitted the utility to recover past operating shortfalls through its PROACT, or deferred cost, account. This account is expected to be fully recovered in July of this year.

Standard & Poor's must now address whether the utilities are on an upward credit trajectory, and, if so, will prospects for improved credit quality continue? Some significant issues remain, including whether the full commission will adopt the compromise plan that its staff negotiated with PG&E. Some additional challenges that are important to credit quality and expected to be resolved or clarified in coming months include:

- ✓ Issues raised by The Utility Reform Network's (TURN) legal challenge to the settlement agreement that SCE reached with the CPUC.
- ✓ The pending general rate cases for SCE and PG&E , which will serve as a barometer of the CPUC's commitment to long-term sound credit quality for the state's investor-owned utilities.
- ✓ The assignment of financial responsibility for the California Department of Water Resources contracts to the utilities, which would likely result in Standard & Poor's imputation of debt-like fixed obligations to the utilities.

CHAPTER 4

MAINTAINING HEADROOM THROUGH 2004

(WITNESS: CHRISTOPHER DANFORTH)

I. INTRODUCTION AND SUMMARY

One of the most expensive components of the PSA between the Energy Division and PG&E is the cost of the Regulatory Asset. Through this ratemaking vehicle, PG&E would essentially capitalize past procurement costs that normally would have been expensed. The need for the proposed Regulatory Asset could be eliminated, or its size substantially reduced, if current rates were extended through the end of 2004. Doing so would allow the accumulation of additional headroom[49] in the Transition Revenue Account ("TRA") and Transition Cost Balancing Account ("TCBA") for one more year than is called for in the PSA. This additional headroom can be used to offset much or all of the debt being financed through the Regulatory Asset under the PSA.

PG&E would amortize about $2.210 billion in debt through the Regulatory Asset in the PSA. With principle, interest, and taxes, the total cost of the Regulatory Asset to ratepayers is $5.412 billion over the proposed 9-year amortization period. Maintaining the rate freeze through December 2004 would generate $952 million in additional headroom. Relying on the restatement of the

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[49] "Headroom" is defined as PG&E's revenues minus expenses. The headroom is currently high because of the various surcharges adopted in 2001 that resulted in approximately a 40% rate increase. As explained further below, the definition of headroom used in the regulatory accounts and the PSA differ in that the latter includes bankruptcy expenses and taxes on revenues.

TCBA and TRA pursuant to Decision ("D.") 01-03-082 produces another $1.241 billion in headroom. These two sources of additional headroom almost completely offset the $2.210 billion Regulatory Asset.

II. ORA'S PROPOSAL

ORA recommends that current rates be frozen through the end of 2004. In early 2005, the sum of the balances in the TCBA, as restated pursuant to D.01-03-082, and the Generation Asset Balancing Account ("GABA") would be calculated and audited. If the net undercollection is less than $1 billion, current rates would be frozen until the net undercollection as shown in the TCBA and GABA is reduced to zero through the normal operation of those accounts. If it is greater than $1 billion, the remaining net undercollection would be financed through securitized bonds, the principal and interest for which would be recovered through a Dedicated Rate Component ("DRC"). The bonds would be amortized over five years. For reasons discussed in Section IV, the DRC would not be grossed up for taxes. Any costs associated with the bankruptcy, such as professional fees and interest costs exceeding those recovered in the regulatory accounts, would be borne by PG&E shareholders through foregone common stock dividends.

Table 4-1 shows the 2002 TCBA ending balance in two ways. The balance in the left column is taken from PG&E's December 2002 TCBA filing. The TCBA balance has been adjusted in the right column based on an accounting restatement pursuant to D. 01-03-082, which PG&E filed in Advice Letter 2240-E-B. Section III explains why the D.01-03-082 restatement caused the 2002 TCBA ending balance to change. A characteristic of this restatement is that the TRA and Generation Memorandum Account ("GMA") balances all close to the TCBA. Since this is not the case in the current monthly TCBA reports, one must physically add the balances in all the accounts to produce the $872 million "TCBA balance" shown in the table for 2002.

TABLE 4-1

NET UNDERCOLLECTION

(Millions of dollars, nominal year-end figures)

	Monthly TCBA Reports		Restated Accounts	
TCBA Balance	872		(369)	
GABA Balance	2,210		2,210	
2002 Undercollection		3,082		1,841
2003 Headroom	(775)-(875)		(775)-(875)	
2003 Undercollection		2,207-2,307		966-1,066
2004 Headroom	(952)		(952)	
2004 Undercollection		1,255-1,355		14-114

In this table, the 2002 TCBA balance is then added to the GABA undercollection of $2.210 billion. The GABA contains the offsetting debit entry for the August 2000 credit entry made in the TCBA for the market valuation of PG&E's hydroelectric plants. Since Appendix C of the PSA would dismiss the proceedings that would approve the August 2000 credit entry, the removal of the credit from the TCBA would have an effect similar to adding the $2.210 billion GABA debit balance to the TCBA balance.

The 2003 headroom numbers shown in Table 4-1 were taken from the PSA.[50] They are probably conservative given that headroom in 2002 was $2.48 billion (Advice Letter 2240-E-B). Depending on what the actual number turns out to be, the rate freeze potentially could be terminated even sooner than December

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[50] The size of this headroom might be affected by the outcome of litigation in A.00-11-038, *et al.,* regarding how a Department of Water Resources refund will be used.

2004. The estimate of 2004 headroom is calculated by combining two pieces of information from PG&E's testimony, the $521 million 2004 revenue requirement associated with the Regulatory Asset[51] and the forecasted $431 million 2004 rate reduction.[52] Without the Regulatory Asset and rate reduction, the headroom would be $952 million ($521 million + $431 million).

The net undercollection at the end of 2003 ($966 to $2,307 million) is less than the approximately $12 billion in debt that the PSA would restructure. Much of this debt pre-existed the 2000 – 2001 energy crisis, and has been used to capitalize electric and gas rate base for which ratepayers regularly pay depreciation, return, and taxes. A significant portion of the debt that was caused by the energy crisis itself will be offset by cash generated through headroom in 2001 – 2003 under the PSA. Thus what remains to be financed at the end of 2003 ranges from $966 - $2,307 million, and can be reduced to $14 - $1,355 million by maintaining current rates for one more year.

The regulatory accounts do not include interest costs and professional fees associated with the bankruptcy that total approximately $1.7 billion.[53] ORA would propose that PG&E bear these costs through its foregone dividends, which PG&E estimates will be around $1.7 billion including the additional $493 million foregone through the PSA. ORA believes that PG&E is responsible for the protracted and costly nature of the resolution of its debt and thus should pay the

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[51] PG&E Testimony, Chapter 10, Table 10-1, also found in Attachment C of Testimony of the Official Committee of Unsecured Creditors.

[52] PG&E Testimony, Chapter 11, page 11-2. This material has been stricken from the record for procedural reasons, but evidences PG&E's position on facts.

[53] See PG&E Testimony, Chapter 12, Table 12A.

$1.7 billion in costs up through the end of 2003 and whatever is incurred by maintaining current rates through 2004.[54]

The headroom also does not reflect the additional income taxes PG&E must pay when revenues exceed expenses. However, the net undercollection in Table 4-1 also does not reflect any tax refunds PG&E may have received resulting from the large undercollections in the year 2000. If the accounts are allowed to operate until the net balance reaches zero, the additional income taxes and tax refunds should cancel. If the undercollection is over $1 billion at the end of 2004, and it has to be financed through a DRC, ORA's proposed tax treatment is discussed in Section IV.

Precedence for ORA's proposed approach of paying off the undercollection entirely with headroom exists in Southern California Edison's ("SCE's") settlement establishing a Procurement Related Obligations Balancing Account ("PROACT"). The PROACT beginning balance of $3.577 billion is very close to the $3.355 August 2001 TCBA ending balance just before PROACT became operational in September 2001.[55] ORA's proposal also bears similarities to the Commission's first Alternative Plan of Reorganization for PG&E, filed February

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[54] If one relies on the monthly TCBA reports and the stated headroom in the PSA, the year-end 2003 TCBA undercollection is remarkably close to the size of the Regulatory Asset in the PSA. If this correspondence is more than mere coincidence, it implies that PG&E shareholders are paying for most, if not all, of the interest costs and professional fees associated with the bankruptcy even under the PSA. If this were not the case, the Regulatory Asset would be too small to capture both the remaining undercollection and these additional costs. Note, PG&E's foregone dividends should, all else being equal, increase PG&E's cash balance, and that cash balance is directly being used to fund repayment of debt under the PSA.

[55] The TCBA ending balance reflects the D.01-03-082 accounting restatement. All headroom was posted to PROACT on a pre-tax basis.

13, 2002, in that headroom is used to pay off the undercollection.[56] Though PG&E found the plan deficient, having 23 months of additional headroom makes the approach more feasible.

III. THE D.01-03-082 ACCOUNTING RESTATEMENT

When the TCBA and its ancillary accounts were restated per D.01-03-082, the treatment of depreciation on plant was changed. Prior to the restatement, $2.2 billion of accelerated depreciation on plant and amortization of regulatory assets was booked to the Accelerated Cost Section of the TCBA in August 2000. These debit balances offset the market valuation credit balance in that month. In September 2000 and subsequent months, there were no more depreciation entries made for plant. When the accounts were restated in Advice Letter 2240-E-B, August 2000 accelerated depreciation entries were reversed.

Since the utility rate base was returned to cost-of-service ratemaking under D.01-01-061, depreciation entries based on plant lives established in the Utility Retained Generation proceeding (A.00-11-038, *et al.*) are applied to the restated TCBA in September 2000 and subsequent months. These depreciation lives are considerably longer than the 4-year amortization period adopted in the transition cost proceeding (A.96-08-001, *et al.*). Replacing a large August 2000 accelerated depreciation entry with subsequent depreciation entries that are cumulatively much smaller than the August 2000 entry has the effect of reducing the net over

56 An important difference between the Commission’s plan and ORA’s proposal is that ORA’s proposal is expressed consistently on a pre-tax basis. Pre-tax headroom is not added to the existing cash balance, which reflects prior tax refunds, to estimate a future cash balance.

collection at the end of 2002 relative to what is found in the December 2002 TCBA report.[57]

ORA believes that the restated accounts better reflect current ratemaking. D.01-01-061 had the effect of essentially restoring PG&E's rate base to what it was prior to August 2000, and ratepayers will be paying depreciation, return, and taxes on that rate base for years to come on that basis. To ignore this adjustment in calculating the net undercollection at the end of 2004 would essentially charge ratepayers twice for these costs, once through whatever bonds are issued to finance the debt remaining after 2004, and once through depreciation, return, and taxes on rate base that was restored but has not been accounted for in the unrestated monthly TCBA reports.

IV. FINANCING THE NET UNDERCOLLECTION IF IT EXCEEDS $1 BILLION

As indicated above, ORA recommends that, if the net undercollection at the end of 2004 exceeds $1 billion, it should be financed through a DRC. For illustration, ORA has calculated the revenue requirement associated with a $1.2 billion securitized bond in Table 4-2. Annual payments under a 5-year

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[57] Between September 2000 and December 2002, only $379 million in depreciation, return, and taxes were flowed through the TCBA under the D.01-03-082 accounting restatement. This is $1.559 billion less than the August 2000 accelerated depreciation entry of $1.938 billion and explains a large percentage of the $1.241 billion difference between the D.01-03-082 restatement and the un-restated monthly TCBA reports for year-end 2002. It is possible that much of the remaining difference can be attributed to differences in interest cost booked to the various accounts since closing the other accounts into the TCBA produces different ending balances every month, to which interest is applied.

amortization at a 5% interest rate[58] would still be considerably less than the some $585 million per year that is contemplated for the Regulatory Asset under the PSA. The total cost of principle and interest over five years would be about $1.350 billion. In essence, ratepayers would be foregoing a $431 million rate reduction in 2004 under the PSA in order to save $4.062 billion ($5.412 billion - $1.350 billion) relative to the Regulatory Asset, for a net savings of $3.631 billion.

TABLE 4-2

ANNUAL REVENUE REQUIREMENT

FOR $1.2 BILLION IN BONDS

(Millions of dollars, nominal)

	2005	2006	2007	2008	2009	Total
Amortization	240	240	240	240	240	1,200
Remaining Debt	1,080	840	600	360	120	
Interest	54	42	30	18	6	150
Total Cost	294	282	270	258	246	1,350

Taxes are excluded from the calculations in Table 4-2 because, under this particular DRC proposal, the debt being securitized is a substitute for additional pre-tax headroom that would be collected if current rates and surcharges were extended through the end of 2005. It has not been reduced or otherwise reflective of PG&E's current cash balance that includes tax refunds for the tax year 2000 net

58 PG&E cites an average interest rate of 6.30% - 6.34% as the cost of new debt assuming an investment grade credit rating. For this illustration, ORA used a slightly lower interest rate to reflect the reduction in risk through securitization. (See PG&E Testimony, Chapter 7, Exhibit I.)

operating loss. Since the size of this net undercollection caused by the 2000-2001 energy crisis is already on a pre-tax basis, and subsequent positive headroom is also on a pre-tax basis, one should not gross up the DRC to reflect taxes. Doing so is equivalent to charging ratepayers twice for taxes.

V. ADVANTAGES OF ORA'S PROPOSAL

The principle advantage of ORA's proposal is the avoidance of $3.631 - $4.967 billion[59] in ratepayer payments related to the Regulatory Asset specified in the PSA. This savings comes from three areas: (1) use of a DRC rather than a Regulatory Asset, (2) differences in the treatment of taxes, and (3) more explicit and potentially precise accounting for the rate reduction bonds ("RRBs") in the TCBA than what might have been considered in developing the PSA. The larger savings estimate is additionally based on using the D.01-03-082 accounting restatement. The first three areas are discussed below.

A. USE OF A DRC AND SECURITIZED BONDS

As discussed in Chapter 5, a DRC allows funding the remaining net undercollection entirely with debt. This approach avoids an expensive return on equity ("ROE") and the gross-up for taxes on the ROE. This yields annual financing costs that are less than half of those associated with a Regulatory Asset. Table 4-2 presents a summary of the costs under ORA's DRC proposal. ORA has not assumed a "mortgage style"

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59 The first figure is the difference between the $5.412 billion cost of the Regulatory Asset and the cost of the DRC in Table 4-2, less the foregone 2004 rate reduction of $431 million. The second figure is the difference between the Regulatory Asset and the minimum $14 million net undercollection shown in Table 4-1, less the foregone $431 million rate reduction.

amortization method as done in the PSA because doing so increases to total interest costs, at least on a nominal basis. ORA estimates that the "mortgage style" approach increases the cost of the PSA's Regulatory Asset by a couple hundred million dollars.

B. ACCOUNTING FOR THE RRBs

The issuance of the RRBs resulted in a large infusion of cash to PG&E in 1998 to fund the 10% rate reduction for four years. The 10% rate reduction reduced headroom that otherwise would have been collected. An advantage of ORA's approach is that it relies on the TCBA balances, and those balances reflect an explicit adjustment made within the TCBA to account for the reduction in headroom from the 10% rate reduction. The TCBA contains credit entries that represent a pro rata allocation of the rate reduction bond proceeds over the four-year transition period. The TCBA also includes credit entries that represent the greater headroom residential and small commercial ratepayers would have been able to contribute had they not had to pay principle and interest on the RRBs.

This money must be explicitly accounted for because ratepayers literally are paying for this 1998 cash infusion to PG&E through principle and interest payments on the RRBs that will not end until 2009. It is unclear whether and how the infusion of cash to PG&E affected the size of the Regulatory Asset. Some of this money might be included in the cash balance that PG&E will rely upon to pay creditors under the PSA, potentially reducing the size of the Regulatory Asset. But it is also possible that the proceeds from the RRBs might have been transferred to the parent company in 1998 with all the other pre-energy crisis headroom, including that allocable to the latter half of 2000 and 2001.[60] ORA simply does not know how it is accounted for in the PSA, if at all.

C. ACCOUNTING FOR TAXES

Finally, there is an advantage of using the balances shown in the regulatory accounts because the way taxes are treated is simple and fair. Tax refunds on undercollections and taxes paid on over collections are assumed to cancel out over time. They cancel because there is an implicit obligation for the Commission to make utilities whole on balancing accounts over time, unless there is a disallowance. Indeed, actual taxes paid at any point in time can differ from what is assumed in rates, but the Commission's main concern is that they balance in the long run. As soon as one departs from this standard regulatory treatment of taxes, one lands in a confusing mess. PG&E has indicated that its tax refunds for its net operating loss in 2000 were only [redacted] billion. This is obviously much less than the taxes applied to the Regulatory Asset. While there may be detailed accounting reasons for this difference, it is much less clear that ratepayers are receiving a fair tax treatment under the PSA. This issue is discussed further in Chapter 7.

VI. CREDIT ISSUES

Some will argue that maintaining the rate freeze for one more year, and delaying the establishment of a funding mechanism to recover any remaining debt, will postpone PG&E's ability to receive an investment grade credit rating. If this

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60 The remaining debt associated with the RRBs are reflected in PG&E's financial statements (See PG&E testimony, Chapter 5), but what happened to the actual proceeds from the RRBs is unclear to ORA.

is true, the question the Commission must ask itself is whether it is worth committing over $5 billion of ratepayer money for an outcome that is uncertain in the near term. As ORA explained in Chapter 3, no guarantee exists that even the plan articulated in the PSA will result in an investment grade credit rating in the near future. Furthermore, immediate return to an investment grade rating may not be essential for PG&E to operate as a utility, serve its ratepayers, and even make capital additions.[61] There are far less expensive ways to address PG&E's debt problem if the Commission and PG&E could tolerate a potential deferral of PG&E's return to an investment grade credit rating.

Reducing the amount of debt being financed under ORA's proposal might actually have a positive impact on PG&E's credit rating by improving various coverage ratios discussed in PG&E's testimony, assuming that off-balance sheet debt associated with a DRC is even considered by rating agencies in deriving credit ratings. PG&E itself admits that it does not know when it will return to an A- credit rating. It is possible that the real tradeoff is between accepting a worse credit rating in the near term to receive an even better credit rating in the future than is expected from the PSA.

VII. CONCLUSION

ORA recognizes that the Commission is under considerable pressure to resolve PG&E's bankruptcy and to work towards restoring PG&E's investment grade credit rating expeditiously. We urge the Commission to have the fortitude to find the current PSA unreasonable, and to modify it to maintain current rates through 2004. ORA recognizes that PG&E's bankruptcy has dragged on for more than two years, while SCE's undercollection is now entirely repaid and a major

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[61] According to the year 2002 Annual Report to Shareholders (cash flow statement, page 81), PG&E made $4.143 billion in capital expenditures between 2000 and 2002.

rate decrease was recently approved. But the delay in PG&E’s case has been caused, at least in part, by the legal remedies that PG&E chose to use to resolve its insolvency, and by PG&E’s persistence until very recently in using its bankruptcy as an opportunity to pursue its agenda of moving its generating assets outside of Commission regulation.

ORA would also urge the Commission to complete its audit of PG&E’s restatement of the TCBA pursuant to D.01-03-082. This restatement shows a very different picture of what ratepayers owe than is contained in either the unrestated monthly TCBA reports or bankruptcy documents. Taking recognition of this fact could avoid the need for an expensive Regulatory Asset all together. The PSA would essentially terminate the TCBA and its ancillary accounts, rendering this very important information forever moot.

CHAPTER 5

POLICY ISSUES

(WITNESS: TRUMAN L. BURNS)

I. SUMMARY

This chapter discusses various policy issues related to the PSA. In summary, the PSA is unfair to ratepayers, unreasonable and not in the public interest; PG&E fails to meet its burden of proof regarding the size of the proposed Regulatory Asset; ORA offers some potential modifications to the PSA, replacing the Regulatory Asset; the PSA results in substantial cash distributions to shareholders; ORA comments on the PSA's impact on gas rates; PG&E should pay all professional fees and expenses from shareholder funds and the Commission should not permit the PSA to prejudge the outcome of the ATCP Phase 2 proceeding, A.01-09-003.

II. POLICY ISSUES

A. In General, The PSA is Unfair to Ratepayers, Unreasonable and Not in the Public Interest

The Scoping Memo and Ruling of the Assigned Commissioner states that included in the scope of this proceeding is "[w]hether the proposed S.A. is fair, reasonable, and in the public interest."[62] Commission Rule of

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[62] Scoping Memo and Ruling of Assigned Commissioner, July 14, 2003, at 1. The Scoping Memo and Ruling and Amended Scoping Memo also refer in section 3c to criteria for

Practice and Procedure 51(e) states that "[t]he Commission will not approve stipulations or settlements, whether contested or uncontested, unless the stipulation or settlement is reasonable in light of the whole record, consistent with law, and in the public interest."

As discussed in particular throughout ORA's Report, ORA concludes that the PSA is unfair to ratepayers, unreasonable and not in the public interest. The PSA unreasonably puts too much of PG&E's debt burden on ratepayers, and given the difficulties in determining how the PSA was constructed and the uncertainty about its outcome, is not in the public interest.

ORA supports a settlement which demonstrates the following reasonable characteristics:

1. The minimum ratepayer expenditure needed to return PG&E to financial strength.
2. A reasonable time for the recovery of debts and the return to creditworthiness.
3. A recognition that the settlement costs result from past utility service, so that large departing load customers bear their fair share of costs.
4. Openness and accountability regarding how costs were determined and allocated.

B. PG&E Fails to Meet its Burden of Proof Regarding the Size of the Regulatory Asset

The heart of the PSA is the $2.21 billion Regulatory Asset.[63] PG&E has made no demonstration that the Regulatory Asset must be that amount

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analysis, citing a SDG&E all-party settlement, D.92-12-019, three class action court cases and the Diablo Canyon settlement, D.88-12-083.

63 PSA at 10, section 2.

to result in a creditworthy utility. ORA attempted to determine how the $2.21 billion figure was determined, but PG&E provided only an inadequate and general answer:

> PG&E objects to this data request to the extent that it requests information regarding the settlement discussions which resulted in the proposed Settlement Agreement. Without waiving this objection, PG&E provides the following information: The regulatory asset is designed to facilitate recovery of PG&E's reasonable costs of providing utility services to its customers. The Regulatory Asset also is set in an amount sufficient to support the financing of the plan of reorganization, to achieve investment grade credit ratings for PG&E as well as the securities to be issued under the plan of reorganization and to help restore PG&E's financial health.
>
> PG&E response to ORA data request 1, Q.3

ORA also requested any sensitivity analyses performed by or for PG&E on the amount and amortization period of the Regulatory Asset. PG&E responded by objecting to ORA's requests, citing confidentiality, attorney-client privilege and attorney work product doctrines.[64]

ORA tried further by asking PG&E "at what level of Regulatory Asset does PG&E lose its investment grade rating, all other elements remaining unchanged? In other words, the proposed Settlement Agreement sets the Regulatory Asset at $2.21 billion; at what lower number does PG&E lose its investment grade rating, all other elements remaining unchanged."[65] ORA addressed its question to PG&E's witnesses Fetter and Murphy. PG&E responded with the following answer:

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[64] PG&E response to ORA data request 10, Q.s 3 and 4.

[65] ORA data request 8, Qs. 8 and 9.

> This question asks an unrealistic hypothetical. By definition, when one reduces the Regulatory Asset, "all other elements" cannot remain unchanged. The quantitative factors used by the credit rating agencies will all deteriorate if the Regulatory Asset is reduced. Mr. Murphy has concluded that, as negotiated, the Settlement Agreement will result in PG&E being accorded "weak investment grade credit ratings of BBB- by Standard and Poor's (S&P) and Baa3 by Moody's Investors Service (Moody's)." (Chapter 7, page 7-3) Mr. Murphy has also concluded that, with respect to the qualitative factors that rating agencies consider, "any substantive change in the terms of the Settlement would significantly impair the ability of PG&E to obtain investment grade credit ratings." (Chapter 7, page 7-4) As Mr. Murphy states in his prepared testimony, "Given S&P's strong emphasis on the importance of regulatory consistency and a supportive regulatory environment, I would view any attempt on the part of the CPUC to substantively alter the terms of the Settlement as being harmful to credit quality." (Chapter 7, page 7-23)

PG&E response to ORA data request 8, Q.9. (The response to Q.8 is substantially similar.)

PG&E's lack of support in its testimony and responses, results in a failure to meet its burden of proof regarding the size of the proposed Regulatory Asset. Essentially, PG&E has focused on the general result of the PSA, and does not want to justify the key input variables, such as the size of the Regulatory Asset. ORA notes that the Commission's April 2002 plan of reorganization covered creditor's claims with the issuance of $1.75 billion in new common equity, a figure significantly lower than the $2.21 billion Regulatory Asset.[66]

[66] Direct testimony of Paul Clanon at 3.

C. Potential Modifications to the Settlement Agreement, Replacing the Regulatory Asset

In lieu of establishing a $2.21 billion Regulatory Asset, the Commission should consider some potential modifications to the PSA that may save ratepayers money. The first option is to **maintain current rates through 2004** without significant rate making changes. This would allow PG&E to continue to use 'headroom' to pay its debts, without the ratepayer costs of the Regulatory Asset. Southern California Edison ("Edison") followed this strategy, and will soon be able to reduce rates. Of course, PG&E's debts are substantially larger than Edison's were. This option is discussed in detail in Chapter 4.

A second option would be to use a **dedicated rate component**, similar to the existing rate reduction bonds.[67] The dedicated rate component would use low cost off-balance sheet debt financing by a creditworthy third party, such as the California Infrastructure and Economic Development Bank. A portion of PG&E's revenue requirements would securitize the debt issued by the third party. Savings would result from the issuance of lower cost debt and reduced returns and taxes versus the cost of the Regulatory Asset.

A third option would be to require PG&E to finance all or a portion of its debts by the **issuance and sale of additional common stock**. While the sale of common stock to raise funds is a common business practice, the PSA prohibits it: "The financing of the Settlement Plan shall not include

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[67] ORA understands that TURN will offer substantial direct testimony on the use of a dedicated rate component.

any new preferred or common stock."[68] PG&E is no doubt concerned about the dilution of its share price that would result from a common stock sale. In contrast to the PSA, the Commission's alternative plan of reorganization (April 15, 2002) called for the issuance of $1.75 billion in new common equity.[69] The Commission later modified its plan to include the issuance of preferred securities in lieu of common equity, and in February 2003, PG&E amended its own plan of reorganization to include the issuance of "up to $700 million on equity."[70] PG&E Corporation currently has over 411 million shares of common stock outstanding, with a closing price of $21.93 as of August 28, 2003.[71]

A fourth option involves the **tax treatment of the Regulatory Asset**. This option is discussed in detail in Chapter 7.

A fifth option involves a **complete financial review of the PSA**, which may result in dollar-for-dollar reductions to the Regulatory Asset. This option is discussed in detail in Chapter 8.

Another option to consider is **reducing the interest expense on PG&E's debts for ratemaking purposes**. According to PG&E, as of July 31, 2003, the company has paid over $1.662 billion in interest on creditor claims.[72] According to PG&E's Disclosure Statement, the interest rates on "currently outstanding securities of the Debtor" range as high as 12

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68 PSA at 19, section 13b.

69 Direct testimony of Paul Clanon at 3.

70 Id.

71 PG&E response to ORA data request 2, Q.5. Stock price from www.pgecorp.com.

72 PG&E response to ORA data request 8, Q.7.

percent.[73] Since PG&E is committed to paying all of its debts in full, PG&E and the Commission should consider finding ways to reduce the associated interest expense for ratemaking purposes.

D. The PSA Results in Substantial Cash Distributions to Shareholders

While PG&E plans on incurring significant new debt to pay its creditors' claims, the company also forecasts that it will be able to distribute substantial amounts of cash to shareholders: $ 3.151 billion from 2005-2008. Page 10 of Appendix 5-A of PG&E's Chapter 5 testimony (Campbell) includes a line labeled, "Common Stock Issued (Repurchased)," with the following figures (end of year):

($ Millions)

2004	2005	2006	2007	2008
0.0	(305.6)	(921.6)	(918.8)	(1005.3)

When asked to explain why these stock repurchases occur, PG&E responded:

> The line labeled "Common Stock Issued (Repurchased)" is intended to show the ability to distribute cash to common shareholders (subject to financing requirements of PG&E and its capital structure targets) through a combination of dividends and repurchases of common stock, without pre-judging a specific common dividend payout level. The distribution to common shareholders (which may be in the form of a dividend) is occurring because PG&E has achieved its target ratemaking common equity

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[73] PG&E Disclosure Statement (June 27, 2003), Exhibit D, at 2. Exhibit B of PG&E's Plan of Reorganization also details interest rates for allowed claims.

> ratio of 52% (excluding Rate Reduction Bonds and short-term debt). If PG&E were to use the cash shown as stock repurchases either to retire debt or to build cash reserves, it would not earn its authorized rate of return on equity unless it increased customer rates.
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> PG&E response to ORA data request 8, Q.1

Assuming that approximately $400 million is used annually for common stock dividends, the total common stock repurchases would total approximately $1.551 billion. To protect the common stock repurchase option, the PSA also includes the following language: "the Commission shall not restrict the ability of the boards of directors of either PG&E or PG&E Corporation to declare and pay dividends or repurchase common stock."[74]

ORA recommends that the Commission reduce the size of the proposed Regulatory Asset to reduce the excess cash PG&E will have available to distribute to common stock shareholders. The Commission should also delete the restrictive language from section 6 of the PSA.

E. The PSA's Impact on Gas Rates

The PSA presents a new wrinkle on the electricity crisis:

> **The cost of financing, including principal, interest**, any fees or discounts payable to investment bankers, capital markets arrangers or book runners, including the fees to be paid to UBS Warburg LLC and Lehman Brothers pursuant to Paragraph 13d, as well as an past or future call premiums on reacquired debt, **shall be fully recoverable as part of the new cost of debt to be collected in PG&E's retail gas and electric rates without further review**.

[74] PSA at 15, section 6.

PSA at 20, section 13f (emphasis added).

PG&E's revenue requirements and post-Chapter 11 ratemaking testimony refers to electric rate changes, but does not include any references to gas rates.[75] PG&E estimates that issuance costs will be about $80 million, and that about 20 percent, or approximately $16 million of the issuance costs will be recoverable in gas rates.[76] PG&E also explained its rationale for recovering financing costs from gas rates: "These costs will, in part, be recoverable in gas rates because PG&E is refinancing all of its debt, including debt that finances assets used in the distribution, storage, and transmission of natural gas."[77]

While the $16 million in issuance costs that would be allocated to gas rates is relatively small, ORA recommends that the PSA be modified to delete the contribution by gas customers. As a matter of fairness, the Commission should not permit costs associated with the electricity crisis to carry over to gas rates. For example, PG&E's gas customers in SMUD's service area would be unfairly charged for these issuance costs.

F. PG&E Should Pay All Professional Fees & Expenses From Shareholder Funds

The PSA has PG&E reimburse the Commission for its professional fees and expenses, recoverable through retail rates:

> PG&E shall reimburse PG&E Corporation and the Commission for all of their respective professional fees and expenses incurred in connection with the

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[75] PG&E testimony, Chapter 10 (Montana).

[76] PG&E response to ORA data request 3, Q.10 Revised.

[77] Id.

> Chapter 11 Case. … The Commission shall authorize PG&E to recover the amounts so paid or reimbursed to the Commission in retail rates over a reasonable period, not to exceed four years. PG&E shall not recover any portion of the amounts so paid or reimbursed to PG&E Corporation in retail rates; rather, such costs shall be borne solely by shareholders through a reduction in retained earnings.
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> PSA at 20-21, section 15.

PG&E estimates that PG&E Corporation's professional fees and expenses will total $125 million through the end of year 2003, and that PG&E's total to date is $237.5 million.[78] The Commission's professional fees and expenses are unclear at this time.[79]

The PSA is silent on whether PG&E can recover its professional fees and expenses from retail rates. According to PG&E, "[s]ection 15 of the Settlement Agreement does not provide for the regulated utility's professional fees and expenses to be recovered from ratepayers in rates, only the CPUC's."[80] The Energy Division Staff offers a non-committal response on the issue:

> Staff objects to this request to the extent that it calls for information or documents described in General

78 PG&E response to ORA data request 3, Q.6 Supplemental; Q.8.

79 PG&E response to ORA data request 3, Q.7. Public Utilities Commission Staff response to ORA data request 2, Q.1 (August 27, 2003), "Staff objects to this request to the extent that it calls for information or documents described in General Objections 1-5, above. Subject to and without waiving these objections or the general objections above, Staff will produce non-confidential information/documents [footnote omitted], if any exist, responsive to this request." Public Utilities Commission Staff did not include any non-confidential information or documents regarding the Commission's professional fees and expenses with its August 27th response.

80 PG&E response to ORA data request 12, Q.1.

> Objections 1-5, above. Staff further objects on the ground that the proposed Settlement Agreement speaks for itself, and thus the information requested is equally available to ORA. Subject to and without waiving these objections or the general objections above, Staff will produce non-confidential information/documents, if any exist, responsive to this request.
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> Public Utilities Commission Staff response to ORA data request 2, Q.2.

An important point to remember is that PG&E's bankruptcy filing was *voluntary*. ORA recommends that PG&E reimburse the Commission for its professional fees and expenses from shareholder funds, and not include them in retail rates. Furthermore, PG&E should be explicitly prohibited from recovering its own professional fees and expenses from retail rates. Both Edison and Sempra were able to resolve their electricity crisis related financial difficulties without voluntarily entering into bankruptcy; PG&E's ratepayers should not be held responsible for the costs of PG&E's attempt to free itself from the Commission's regulation.

G. The Commission Should Not Permit the PSA to Prejudge the Outcome of the ATCP Phase 2 Proceeding

The PSA contains language regarding the pending Annual Transition Cost Proceeding ("ATCP"), A.01-09-003:

> and on or as soon as practicable after the Effective Date, the Commission shall resolve Phase 2 of the presently pending ATCP Application with no adverse impact on PG&E's cost recovery as filed.
>
> PSA at 17, section 9.

PG&E filed its Phase 2 testimony on January 11, 2002. ORA submitted testimony on April 28, 2003, regarding the reasonableness of PG&E's power procurement practices, recommending a $434 million disallowance. PG&E served rebuttal testimony on July 9, 2003, 14 days after the scheduled service date, opposing ORA's recommendations. ALJ Barnett took hearings off calendar on June 24, 2003.[81] In this proceeding, PG&E expresses its *opinion* that ORA is unlikely to prevail on its disallowance recommendation, citing its own belated rebuttal testimony.[82]

ORA recommends that the ATCP Phase 2 language be removed from the PSA. The Commission should not prejudge a pending application without appropriate due process. The ATCP proceeding has neither gone to hearings, nor been briefed or settled. If PG&E is so certain that it will prevail in the ATCP Phase 2 proceeding, as stated in PG&E's ATCP rebuttal testimony, the company should not object to continuing that proceeding to its end. The Bankruptcy OII is not the appropriate proceeding to resolve the ATCP Phase 2 application.

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[81] CPUC Daily Calendar, June 24, 2003 at 10.

[82] PG&E testimony, Chapter 12, (McManus) at 12-14 to 12-15.

CHAPTER 6

ENVIRONMENTAL ISSUES

(WITNESS: TRUMAN L. BURNS)

I. SUMMARY

This chapter discusses various environmental issues related to the PSA. In summary, ORA recommends that the proposed Land Conservation Commitment needs additional clarifications; the Clean Energy Technology Commitment should be removed from the PSA, and that the proposed funding of $15 million be deducted from the Regulatory Asset.

II. ENVIRONMENTAL ISSUES

A. PG&E Lands

The PSA includes proposed environmental protections and enhancements.[83] According to PG&E, the utility owns approximately 144,000 acres of watershed lands associated with its hydroelectric generating system and the approximately 655-acre Carizzo Plains property.[84] The PSA states that PG&E shall establish a

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[83] PSA at 21-23, section 17 and Appendix E. PG&E's prepared testimony, Chapter 3, Appendix 3-B, includes maps of the watershed lands and Carizzo Plains, although the maps lack useful information, such as the names of nearby cities or roads. ORA assumes that the watershed lands referred to in the PSA are roughly equivalent to the watershed lands previously discussed in the Draft Environmental Impact Report for A.99-09-053 (Nov. 2000).

[84] PG&E certainly owns additional lands that are excluded from the PSA, such as lands surrounding Diablo Canyon. It is not clear why PG&E limited itself to only watershed lands and the Carizzo Plains property.

California non-profit corporation, PG&E Environmental Enhancement Corporation ("PG&E EEC"), "to oversee the Land Conservation Commitment and to carry out environmental enhancement activities."[85] The governing board of the PG&E EEC would include one representative each from PG&E, the Commission, the California Department of Fish and Game, the State Water Resources Control Board, the California Farm Bureau Federation and three public members to be named by the Commission.[86] Under the PSA, PG&E would fund the PG&E EEC with $70 million in cash paid in installments, and "[t]he Commission shall authorize PG&E to recover these payments <u>in retail rates without further review</u>."[87]

The watershed lands and Carizzo Plains would be subject to conservation easements or donated in fee simple to public agencies or non-profit conservation organizations:

> The Watershed Lands and Carizzo Plain shall (1) be subject to permanent conservation easements restricting development of the lands so as to protect and preserve their beneficial public values, and/or (2) be donated in fee simple to one or more public entities or qualified non-profit conservation organizations, whose ownership will ensure the protection of these beneficial public values. PG&E will not be expected to make fee simple donations of Watershed Lands that contain PG&E's or a joint licensee's hydroelectric project features. In instances where PG&E had donated land in fee, some may be sold to private entities subject to conservation easements and others, without significant public interest value, may be sold to private entities with few or no restrictions.

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[85] PSA at 22, section 17b.

[86] It is not clear why the California Farm Bureau Federation is included on the board, as opposed to environmental advocacy organizations, such as California Hydropower Reform Coalition or Environmental Defense.

[87] PSA at 23, section 17c, emphasis added.

PSA at 34, Appendix E.

The PSA does not specify the disposition of individual properties. The PSA also states that the watershed lands and Carizzo Plains are “worth an estimated $300 million.”[88]

B. ORA Investigation

Given an extremely short time frame, ORA conducted some discovery on the PSA Land Conservation Commitment. ORA requested work papers supporting the $300 million valuation of the watershed lands and Carizzo Plains properties. PG&E responded that there are “no such workpapers”[89], and that the valuation “is PG&E’s estimate. It is not based on an appraisal or other formal valuation, but on PG&E’s understanding that Sierra lands are worth $2000 per acre or more on average. Also, a March 9, 2001 *Los Angeles Times* article estimated that the watershed lands alone are worth $370 million.”[90]

ORA requested work papers supporting the proposed $70 million level of funding for the PG&E EEC; PG&E responded by objecting to the data request and stating that there are “no such work papers”[91] and that the funding level “was a negotiated amount.”[92]

Since the PSA states that the Commission shall authorize PG&E to recover the $70 million in funding for the PG&E EEC “in retail rates without further review,” ORA asked PG&E if funds for the PG&E EEC are spent improperly,

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88 PSA at 22, section 17.

89 PG&E response to ORA data request 1, Q.14.

90 J. Malkin letter at 1, July 25, 2003.

91 PG&E response to ORA data request 1, Q.15.

92 J. Malkin letter at 2, July 25, 2003.

would the Commission still be required to authorize PG&E to recover further payments without further review. PG&E responded in the affirmative: "Yes. PG&E's sole responsibility will be to collect the money in rates and turn it over to PG&E Environmental Enhancement Corporation. PG&E will not control the spending of the money by PG&E Environmental Enhancement Corporation."[93]

ORA also asked PG&E how much land it plans on donating to conservation groups, and received a non-committal response: "The governing board of [PG&E EEC] will develop a plan for the protection of the lands for the benefit of the public. That plan will include both donations in fee and conservation easements. Until the [PG&E EEC] board is formed and completes its work, it is not possible to state how much land PG&E will donate in fee."[94] PG&E was equally non-committal about the extent of conservation easements: "Until the board is formed and completes its work, it is not possible to state how much land PG&E will encumber with conservation easements."[95]

The potential ratepayer costs and benefits for the proposed Land Conservation Commitment are important to ORA and to the propriety of the PSA. ORA asked about the potential ratepayer costs and benefits associated with the conservation easements. PG&E responded with an inadequate summary of costs and benefits:

> Ratepayers and all other residents of California will benefit from conservation easements because they conserve land for a broad range of beneficial public values, including the protection of the natural habitat of fish, wildlife and plants, the reservation of open space, outdoor recreation, sustainable forestry, agricultural uses, and historic values. The ratepayer costs associated with conservation easements would be those

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[93] PG&E response to ORA data request 1, Q.16.

[94] PG&E response to ORA data request 1, Q.19.

[95] PG&E response to ORA data request 1, Q.20.

> from the funding of the PG&E Environmental Enhancement Corporation. **We do not anticipate that the IRS will allow any tax benefits to be associated with the creation of the conservation easements**.

PG&E response to ORA data request 1, Q.21, emphasis added.

The environmental review process under the California Environmental Quality Act ("CEQA') could be an important element of PG&E's proposal. ORA asked PG&E whether the donation of conservation easements would require review by the CPUC under CEQA. PG&E responded that the company "will apply to the CPUC for approval under Public Utilities Code section 851 of any donations of conservation easements to be made pursuant to the settlement agreement. At that time, the CPUC will perform the appropriate CEQA review."[96] PG&E provided a similar response regarding land donations.[97]

Finally, ORA inquired about the interaction between the proposed duties of the PG&E EEC and PG&E's obligations under its FERC licenses for hydroelectric facilities. PG&E responded that "PG&E's obligations under its FERC licenses remain obligations of PG&E and nothing in the agreement transfers any of those obligations or duties to another party. Neither the settlement agreement nor any actions by PG&E EEC will supersede any of PG&E's obligations under its FERC licenses."[98]

C. Discussion & Recommendation

As presented in the PSA, the Land Conservation Commitment needs additional clarifications. At this point, it is essentially an agreement to do something in the future, but without much definition. To provide balanced

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96 PG&E response to ORA data request 3, Q.1.

97 PG&E response to ORA data request 3, Q.2.

98 PG&E response to ORA data request 3, Q.11.

representation, the governance of the PG&E EEC needs to include ORA and environmental advocacy organizations. Appendix E of the Land Conservation Commitment refers to a process for the development of the conservation easements and land donation plan[99], but without a necessary schedule or timetable for completion. Beyond land uses, minimum and optimal stream flows should also be considered in the Land Conservation Commitment. Furthermore, since the $70 million funding level was a negotiated figure, there is no justification for whether this amount is reasonable for the proposed tasks. Before the establishment of a PG&E EEC, inclusion of appropriate financial controls will also be necessary since the PSA states that "[t]he Commission shall authorize PG&E to recover these payments <u>in retail rates without further review</u>."[100]

While the essential purpose of the PSA is to resolve PG&E's financial woes, the land conservation issues included in the PSA are also important to ratepayers. The Land Conservation Commitment does not appear to generate any immediate additional cash for the PSA, certainly not $300 million; in fact, it creates the additional $70 million cost of funding the PG&E EEC. Those costs weigh favorably against the intangible environmental benefits that will result from land conservation. ORA is surprised that PG&E believes that the IRS will not allow any tax benefits associated with the creation of the conservation easements; if this is true, it undermines part of the purpose of creating the conservation easements.

ORA recommends that the Commission consider the modifications offered above to clarify the Land Conservation Commitment. ORA notes that the Commission has already begun a process to review utility environmental issues in

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[99] Appendix E at 35.

[100] PSA at 23, section 17c, emphasis added.

the so-called Sustainability OIR, R.03-03-015; that proceeding may be the logical place for further review.

D. Clean Energy Commitment

The PSA also includes a so-called "Clean Energy Technology Commitment" ("CETC").[101] The CETC would establish an as yet unnamed California non-profit corporation "dedicated to supporting research and investment in clean energy technologies primarily in PG&E's service territory." PG&E would fund the new non-profit corporation over five years with $15 million of shareholder funds: "The Commission shall not include any portion of this funding in PG&E's retail rates." Further funding is somewhat vague: "PG&E and the Commission shall work together to attract additional funding for the non-profit corporation." The non-profit corporation would have a board consisting of nine members, three appointed by the Commission and PG&E, and the remaining three selected jointly by the Commission's appointees and PG&E's appointees. PG&E's testimony states that "[t]he non-profit corporation will function as an incubator to spur investment, research, development and implementation of new clean technologies."[102] Neither the PSA nor PG&E's testimony defines the term "clean energy technology."

While ORA sees ratepayer benefits in the Land Conservation Commitment, we see little to recommend the CETC. The essential purpose of the PSA is to resolve PG&E's financial woes, but the company apparently has $15 million that it wants to spend on a new initiative. PG&E is already authorized to collect approximately $390 million annually for public purpose programs, of which $32.6 million is spent on research, development and demonstration ("RD&D")

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101 PSA at 23, section 18.

102 PG&E testimony, Chapter 3, at 3-5.

projects.[103] The additional $15 million for the CETC represents 46 percent of present RD&D funding. Ratepayers would be better off if PG&E deducted the $15 million for the CETC from the proposed $2.21 billion Regulatory Asset. ORA recommends that the CETC be removed from the PSA, and that the proposed funding of $15 million be deducted from the Regulatory Asset.

[103] PG&E Chapter 11 workpapers at 15, ln. 113.

CHAPTER 7

INCOME TAX ISSUES

(WITNESS: JOSEPH R. CABRERA)

I. SUMMARY AND RECOMMENDATIONS

This Chapter discusses the various income tax issues contained in the Proposed Settlement Agreement (PSA). Federal and California state income taxes are a significant cost component associated with the Regulatory Asset. Ratepayers and interested parties should be made aware of how taxes significantly add to the overall cost of the Regulatory Asset. ORA reviewed PG&E's testimony, exhibits and responses to ORA data requests in order to assess the overall income tax implications of the PSA.

ORA recommends the following:

1. The Commission should seriously consider the tax implications of the PSA. The associated tax costs are approximately the same amount as the Regulatory Asset value itself. The Commission should limit the total federal income tax costs of the Regulatory Asset that PG&E may recover in rates to the amount of federal tax savings realized by PG&E as a result of the unrecovered energy costs that were deducted as net operating losses ("NOLs") on PG&E's federal income tax return(s).

2. The Regulatory Asset Revenue Adjustment Mechanism (RARAM) or other Tracking Account is the appropriate method to track the amounts recovered from PG&E from generators or other energy suppliers in order to provide for the opportunity to determine if the recoveries are fully taxable or not. To the extent these recoveries exceed the tax savings realized from the net operating losses, the Regulatory Asset should be reduced dollar for dollar.

3. The estimated state income taxes recoverable in rates should be recalculated using a Regulatory Asset tax basis of [redacted] billion. This represents that portion of PG&E's 2000 California net operating loss which could not be deducted.

II. THE TAX COST OF THE REGULATORY ASSET IS HIGH.

The PSA provides for recovery of income taxes in two ways: First, the annual amortization of the Regulatory Asset will be Tax-Effected. This means that federal and state income taxes, grossed-up, will be added to the revenue requirement. The total annual Regulatory Asset amortization Tax Effect projected over the amortization period is $1.520 billion. Secondly, the annual Regulatory Asset amortization will include an average annual return on rate base component, grossed-up for taxes. The total amount of the taxes included in the average annual return on rate base component is $480.8 million. In other words, ratepayers will be paying over $2 billion in income taxes on a Regulatory Asset amount of $2.210 billion. Further, the amount of federal income taxes projected to be collected in rates exceeds the federal tax savings realized by PG&E as a result of the deducted unrecovered energy costs. PG&E represents that it received approximately [redacted] billion in federal income tax refunds as a result of the NOLs created by the energy crisis.[104]

Ratepayers will pay more income taxes included in the Regulatory Asset's revenue requirement than PG&E recovered in income tax refunds after deducting the underlying cost (unrecovered energy costs) of the Regulatory Asset. In other words, ratepayers will pay more in taxes on the Regulatory Asset than the tax value of the unrecovered energy costs. This is inequitable to ratepayers. Thus the federal income tax costs of the Regulatory Asset recoverable in rates should be limited by the amount of federal income tax benefits realized by PG&E as a result of the unrecovered energy costs.

A. Did Ratepayers Benefit From the Actual Tax Refunds?

Ratepayers should know whether or not the amount of the Regulatory Asset was mitigated (reduced) by the actual federal and state income tax refunds

[104] PG&E Response to ORA Data Request 11. PG&E asserts this Response contains confidential information.

received by PG&E as a result of the NOL sustained in tax year 2000. However, the details of how, if ever, the refunds were included in the calculation of the Regulatory Asset are guarded secrets; the parties to the settlement discussions claim they are legally prohibited from disclosing such information.[105] According to PG&E's testimony,[106] the amount of the Procurement Cost Undercollection as of January 1, 2003 is $9.707 billion, while the after tax amount is $3.894 billion less, or $5.813 billion. This suggests that PG&E should have received income tax refunds of approximately $3.894 billion, not [redacted] billion as PG&E represents.[107] Therefore, ORA poses the obvious questions: (1) what happened to [redacted] billion in federal and state income tax refunds? (2) Why should ratepayers be forced to pay over $2 billion in projected tax costs while there is a huge discrepancy between the purported tax refunds and the projected tax costs of the Regulatory Asset? Further, the amount of the actual NOL allocable to the regulated company is unclear, as well as how, if ever, income tax refunds were accounted for when determining the amount of the Regulatory Asset.

B. How Were the Tax Refunds Included in the Regulatory Asset Value?

According to PG&E, there is no relationship between the tax benefits realized as a result of the tax year 2000 NOLs and the size of the Regulatory Asset.[108] However, in discussions with PG&E staff, ORA was told that the tax

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[105] PG&E refused to disclose this information claiming that, anything that might be considered "workpapers" supporting the determination of the amount of the Regulatory Asset would be materials prepared as part of the settlement discussions; pursuant to the June 19, 2003 Order in *In re Pacific Gas and Electric Company,* in the United States Bankruptcy Court such material "shall not be subject to discovery."

[106] Chapter 12, Claims By and Against PG&E, page 12-4.

[107] PG&E Response to ORA Data Request 11, 8-28-03.

[108] PG&E Response to ORA Data Request 3, Q. 4.

refunds included in the cash balance served to reduce the amount of unrecovered energy costs included in the Regulatory Asset, and in that way, ratepayers receive the benefit of the refunds.[109] PG&E has not substantiated this claim and ORA has not seen evidence to support the contention that the Regulatory Asset was reduced by any amount of tax refunds. PG&E has refused to allow ORA access to the people and documents supporting the settlement numbers.[110]

PG&E asserts that ratepayers do benefit from the purported [redacted] billion dollars in income tax refunds in that the refunds have contributed to the company's cash available for paying creditor claims and other expenses. The cash balance, therefore, reduces PG&E's debt financing requirements as well as serves to strengthen the company's overall financial profile.[111] According to PG&E, the cash on hand available to pay creditors (purportedly including the [redacted] billion of tax refunds) and the Regulatory Asset are two inputs into PG&E's expected 2004 financial performance.[112] If this is the case, why is only [redacted] billion in tax refunds being considered while the estimated tax cost of the Regulatory Asset is over $2 billion?

If the cash balance available to PG&E included the tax refunds actually collected, and the Regulatory Asset was reduced by the tax refund amounts, then the Regulatory Asset directly includes the tax benefits of the unrecovered energy costs. However, parties such as ORA, not involved with the settlement discussions cannot ascertain whether or not the tax refunds were considered in determining the amount of the Regulatory Asset with any degree of certainty. At best, an inference can be made that at least indirectly, the tax refunds served to

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[109] Meetings at PG&E Headquarters on August 7 and 12, 2003.

[110] ORA Attorney Letter to PG&E dated August 20, 2003.

[111] PG&E Response to ORA Data Request 3, Q. 5.

[112] PG&E Response to ORA Data Request4, Q. 3.

mitigate the amount that PG&E must borrow to pay creditor claims, thereby minimizing the cost of borrowing. Since the actual amount of federal and state income tax savings PG&E received as a result of the tax losses caused by the unrecovered energy costs is not known, then the estimated federal income tax costs associated with the Regulatory Asset should be limited to the represented [redacted] billion in federal income tax refunds received by PG&E. This amount serves to place an objective tax value on the associated Regulatory Asset, and by default, a yard stick by which the federal income tax cost of the Regulatory Asset could be measured.

It is unfair to ratepayers to estimate projected tax costs of the Regulatory Asset using conventional regulatory tax models while tax refunds based upon cash basis accounting are allegedly being used to offset the Regulatory Asset amount. ORA recommends that PG&E's recovery in rates of the total federal income tax costs associated with the Regulatory Asset be limited to the amount of federal income taxes saved by PG&E as a result of deducting the relating losses on their federal income tax returns as NOLs.

III. THE REGULATORY ASSET'S TAX BASIS.

For federal income tax purposes it is reasonable to assert that the Regulatory Asset does not have a tax basis because the associated cost of the asset (unrecovered energy costs) was deducted as NOLs in years prior to 2000 in the form of net operating loss carrybacks. In other words, for federal income tax purposes, the tax basis of the unrecovered energy costs was used to offset taxable incomes in prior years and cannot be used to offset the taxable income generated from recovering the Regulatory Asset in future years. This is analogous with depreciable real property whose cost has been fully depreciated and is subsequently sold; the entire gain is taxable without the offset for tax cost (basis). Therefore, the Regulatory Asset has no tax basis left for *federal income tax* *purposes*, and the recovery of the asset, amortized into rates over the amortization period, is taxable income for federal purposes without an associated expense to offset it.

However, for *California state income tax purposes*, ORA calculated a tax basis of [redacted] ([redacted] billion), which represents that portion of PG&E's 2000 California NOL that could not be deducted in 2001 and 2002.

California tax law does not provide for a net operating loss carryback. Only 55% of the year 2000 loss can be *carried forward* for a five-year period for net operating losses incurred in income years beginning after 1999. Further, for tax years 2002 and 2003, California suspended the use of NOL carry-forwards against 2002 and 2003 taxable incomes. For PG&E, 55% of its 2000 California NOL amounted to [redacted] Therefore, approximately [redacted] represents the total 2000 state NOL of which [redacted] could not be deducted (disallowed 45% portion) because of the 55% limitation.[114] Because California suspended the use of NOL carry-forwards for income years 2002 and 2003, [redacted] of PG&E's deductible portion of its state NOL ([redacted]) is unused. Therefore, a total of [redacted] ([redacted] plus [redacted]) is unused and available to add to the tax basis of the Regulatory Asset for state income tax purposes.

A. Tax Cost Basis Adjustments Under IRC Section 1091.

There is an analogous provision in the income tax law which serves to further explain ORA's position. IRC Section 1091 provides for an upward (tax

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[113] PG&E's Response to CPUC's April 29, 2002 Information Request No.3, dated May 13, 2002, Request No. 8(i). Also, Response to ORA DR 11, 8-28-03. PG&E asserts these Responses contain confidential information.

[114] [redacted] billion less [redacted] billion = [redacted] billion.

[115] PG&E Response to ORA Data Request 11, 8-28-03. PG&E assert this response contains confidential information.

cost) basis adjustment for certain sales of stock or securities under the wash sale rules. A tax deduction for a loss sustained on a sale of stock or securities is not allowed if, within a period beginning 30 days before the date of the sale and ending 30 days after that date, the taxpayer has reacquired the same stock. When a tax loss (deduction) is disallowed because of the wash sale rules, the amount of the disallowed loss is *added* to the cost of the new stock or securities acquired within the aforementioned 60-day period. The result is that the new tax basis (cost) of the stock or securities *includes* the loss that could not be deducted because of statutory limitations, and the taxpayer enjoys the tax benefit of the higher tax cost of the new stock or securities when they are subsequently sold. The California income tax rules for wash sales are the same as the federal rules.[116]

The statutory limitations applicable to the California state NOL deduction is analogous to the wash sale rules. 45% of PG&E's state (tax year 2000) NOL was not allowed as a deduction, as well as that unused portion which could not be deducted in tax year 2002 because of the NOL carry-forward suspension. Therefore, the unused tax losses should be added to the tax basis of the Regulatory Asset for state income tax purposes.

ORA recommends that the estimated state income taxes recoverable in rates be recomputed to reflect a state income tax basis of [redacted] billion. This is the amount of the tax losses stemming from unrecovered energy costs that has not been deducted for state income tax purposes and is available to offset taxable income from the Regulatory Asset amortization.

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116 California law incorporates the federal law by reference.

IV. BALANCING ACCOUNTS AND INCOME TAXES

Part of the difficulty in calculating the tax effects of the PSA is that it combines funding mechanisms that are after-tax (cash) with elements, which are pre-tax (2003 headroom and revenue requirement associated with the Regulatory Asset). This problem could have been avoided had the Regulatory Asset been sized to equal the net under-collection in the relevant regulatory account(s) at the time when it is consummated. Such a proposal is discussed in Chapter 4.

Income taxes are not usually accounted for in balancing accounts. Balancing accounts used to account for energy costs have traditionally excluded concerns for income taxes. The issue of income taxes may arise because substantial over-or under-collections at the end of a taxable year may affect a utility's actual tax liability. The result is that in a period where there is an over-collection, actual income taxes may be higher than book, and when there is an under-collection, actual income taxes may be lower than book.

Rather than adjusting rates up or down for taxes as under-or over-collections change from year to year, income taxes are ignored on the basis that balancing account adjustment procedures tend to level out between periods. In other words, periods of over-collection will be followed by periods of under-collection so that over the long term, income tax expense will balance out. It is reasonably assumed that any imbalance will be corrected in subsequent periods so that ratepayers and utilities are both adequately protected.

V. REGULATORY ASSET TAX BALANCING ACCOUNT (RATBA).

There has been much discussion and ensuing confusion over the matter of the RATBA. The purpose of the RATBA is to protect PG&E from the possibility that the taxing authorities will consider the Regulatory Asset income in the year that PG&E is given regulatory approval to collect on the Regulatory Asset. It appears that at the time of the settlement discussions, the parties considered the possibility that the Regulatory Asset could carry an immediate tax cost as a result of recognizing it, in its entire amount, as taxable income in one year. If there is no balancing account and PG&E were taxed in one year, it would change the entire financial structure of the post-bankruptcy PG&E in that there would be a one time larger tax cost associated with the Regulatory Asset. Ratepayers, at least indirectly, benefit from this balancing account in that should PG&E be taxed in one year, it could result in higher debt costs. ORA does not object to this balancing account and finds it to be a prudent risk management strategy.

PG&E's position is that the Regulatory Asset should be taxable as it is amortized (collected in rates) over the amortization period.[117] At this time, PG&E does not plan to seek an Internal Revenue Service advanced ruling on this issue. ORA concurs with this tax position as there are no rules or regulations that support inclusion of the Regulatory Asset into taxable income in the year PG&E receives regulatory approval.

The Regulatory Asset represents a receivable due from ratepayers payable over the amortization period. It is ORA's opinion that in order for the Regulatory Asset to be taxable in one period, PG&E must have constructive receipt of the income. Constructive receipt occurs when income is credited without restriction and made available to a corporate taxpayer. However, for tax purposes, the Regulatory Asset carries with it significant restrictions and limitations over how and when it is collected. There must be no substantial limitations or conditions on PG&E's right to bring the Regulatory Asset within its control in order for the Regulatory Asset to be considered constructively received in the year of regulatory approval.[118]

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[117] PG&E Response to ORA Data Request 4, Q. 4.

[118] IRC Section 451, Income Tax Regulations at Section 1.451.

VI. THE REGULATORY ASSET WILL BE OFFSET, *NET OF TAX*, FOR ANY REFUNDS PG&E MAY RECOVER FROM ENERGY SUPPLIERS.

The PSA provides for the Regulatory Asset being reduced, dollar for dollar, by any refunds that PG&E is able to recover from suppliers, *net of tax*. That is, any amounts that reduce the Regulatory Asset will be on an after-tax basis. For every dollar recovered, estimated federal and state income taxes will be deducted (withheld), and the net amount used to reduce the Regulatory Asset. This is because the refunds received, if any, will represent taxable income to PG&E. Refunds from suppliers are taxable income because the energy costs incurred by PG&E in 2000 and 2001 created tax deductions. Under the tax benefit doctrine of the Internal Revenue Code (IRC), amounts previously deducted against taxable income and subsequently recovered are taxable revenues *to the extent that the costs incurred reduced PG&E's tax liability* in a prior year.[119] This last point is a critical distinction in the law because it creates an upper limit in which refunds or other recoveries are considered taxable income. Therefore, there is an upper limit to which taxes can be "withheld" from refunds received from suppliers. It is in the best interest of ratepayers to maximize every dollar reduction in the Regulatory Asset.

PG&E cited IRC Section 451[120] to support the conclusion that any amounts received as refunds, claim offsets or other credits from generators or other energy suppliers are taxable income.[121] In ORA's opinion, this IRC section has limited applicability to this issue because it provides only for the proper year of inclusion in taxable revenue amounts of gross income under the method of accounting used by PG&E in computing taxable income (see discussion on the RATBA). In ORA's opinion, it is not the operative IRC section. Instead, IRC section 111 is the more pertinent section. Under this code section, the receipt of an amount that was part of an earlier deduction or

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119 IRC Section 111.

120 PG&E Response to ORA Data Request 4, Q. 1.

121 Also see Proposed Settlement Agreement, Exhibit to Prepared Testimony, section 2(d).

credit is considered a taxable recovery and generally must be included, partially or totally, in income in the year of receipt. Common types of recoveries are refunds, rebates, credits and reimbursements. However, under IRC section 111(b), recoveries of amounts for which a deduction was claimed in prior tax years must be included in taxable income *to the extent the deduction(s) reduced PG&E's tax liability in the year of the deduction.* In other words, to the extent that PG&E recovers more than the amount of taxes it saved as a result of the tax deductions associated with energy costs, *the Regulatory Asset should be reduced dollar for dollar, without the necessity of "withholding" taxes.*

PG&E represents that it received approximately [redacted] billion dollars in federal and state income tax refunds. Therefore, it is reasonable to conclude that any energy costs that PG&E is able to recover from suppliers would carry a maximum tax cost of [redacted] billion, which represents *the extent the associated deduction(s) reduced PG&E's tax liability in the year of the deduction(s).* Therefore, ORA recommends that refunds or other recoveries that PG&E is successful in collecting that exceed the tax benefit of the underlying tax losses be used to reduce the Regulatory Asset dollar for dollar.

The PSA does not provide for a method of tracking the amount of refunds from generators and other energy suppliers. However, PG&E's Prepared Testimony Chapter 10, Section C proposes that the RARAM account (which will track the amortization of the proposed Regulatory Asset) be used to track any credits resulting from refunds or other credits from suppliers. ORA recommends that this balancing account also track any refunds gross of tax. In the alternative, a separate Tracking Account should be used to track any refunds gross of tax in order to protect ratepayers in the event that PG&E is successful in recovering refund amounts which exceed the tax benefits of the associated costs realized in prior years. The Tracking Account would track all amounts received from generators or other energy suppliers in which PG&E successfully collects refunds, rebates, credits and other reimbursements.

VII. CONCLUSIONS

The current terms of the PSA provide for a tax cost which is not commensurate to the underlying tax value of the Regulatory Asset. In other words, the PSA provides a Regulatory Asset tax carrying cost that exceeds its underlying tax value as measured by the amount of federal and state income tax refunds received by PG&E as a result of the NOL in 2000. The estimated tax of the Regulatory Asset recoverable in rates almost equals the value of the Regulatory Asset itself.

The tax value of the Regulatory Asset is more closely related to the tax savings realized by PG&E after deducting unrecovered energy costs on federal and state income tax returns. In other words, the tax value of the Regulatory Asset is more closely related to the tax benefits associated with the asset’s true nature; unrecovered energy costs. Therefore, ORA recommends that for federal income tax purposes, the amount of federal income taxes recoverable in rates be limited to the amount of federal income benefits realized by PG&E after deducting the federal NOL. For state income tax purposes, the estimated state income taxes should be recalculated using a Regulatory Asset tax basis equal to the portion of PG&E’s state NOL that could not be deducted.

Therefore, ORA recommends that the tax cost of the Regulatory Asset be minimized to the extent possible.

CHAPTER 8

FINANCIAL REVIEW

(Witnesses: Mark Kent Bumgardner, MBA, CPA, and Mark Waterworth, CPA)

I. SUMMARY AND RECOMMENDATIONS

The purpose of this chapter is to address ORA's review of the key financial data that was the basis for the PSA. ORA's review was hampered by PG&E's refusal to provide access to facilities, people and supporting documents. The primary findings are that:

- ✓ The amount of available cash is understated by $687 million;
- ✓ The uses of funds is overstated by $424 million;
- ✓ The ratepayer's contribution is understated by $1,882 million;
- ✓ The shareholders' contribution is overstated by $315 million; and;
- ✓ The regulatory asset is understated by $145 million.

II. INTRODUCTION

ORA's review of financial data included in the PSA consisted principally of applying analytical procedures to financial data and making inquiries of persons responsible for the financial data. The scope of ORA's review is difference from an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, ORA does not express such an opinion. During its financial review ORA attempted to:

1. Review the Scoping Memorandums ("SM")
2. Review the PSA;

3. Review PG&E's testimony and workpapers for issues and supporting documentation;

4. Review Energy Division's testimony and workpapers for issues and supporting documentation;

5. Obtain an understanding of the financial numbers used in developing the PSA; and,

6. Verify the financial basis of the PSA.

III. LACK OF COOPERATION FROM PG&E

At the start of ORA's financial review to verify the basis of the numbers used by Energy Division and PG&E in the PSA and their testimony, ORA submitted a written data request on some of the key financial numbers and corroborating financial numbers, to begin its analysis. PG&E, in its response, refused to provide ORA with the access to the financial numbers, the documents supporting these numbers, and the people at PG&E who were responsible for these numbers. This lack of access of made it impossible for ORA to perform a reasonable review of the financial basis of the PSA.

In PG&E's response it indicated that it objected on the "grounds that a financial review is outside the scope of this proceeding as set forth in the July 14, 2003, Scoping Memo and Ruling of Assigned Commissioner ("Scoping Memo"). PG&E further objects to this request to the extent that it calls for information to be provided to ORA in connection with an ORA audit of PG&E's accounting system that is not relevant to the criteria for evaluating the settlement as set forth in the Scoping Memo, and is not reasonably calculated to lead to the discovery of admissible evidence. PG&E objects on the further ground that it is unduly burdensome." "Subject to these objections and without waving them, PG&E will provide information and documents in response to the other questions in this data request, as set forth in those responses." (PG&E response to data request ORA-6, question 1). ORA made several attempts to contact PG&E's project manager, and case attorney to no avail, and mailed PG&E's attorney a letter on August 20, 2003, requesting access. On August 21, 2003, Mr. Malkin, responded indicating that

PG&E declined to provide ORA access because there were several audits performed two to five years ago, and Energy Division is currently auditing the Transition Revenue Account ("TRA"), TCBA, generation memorandum accounts, etc. through 2003 (August 21, 2003 letter from Mr. Malkin to Mr. Cagen). ORA needed access to current information to ensure that the numbers used in the PSA are valid, and determine that PG&E is using the correct source. ORA views PG&E and its attorney's actions as an attempt to prevent a full review of the numbers in this case.

PG&E's response violates the California Public Utilities Code ("PU Code"), the PSA, and the SM #1.

PU Code § 581 states that "Every public utility shall furnish to the commission in such form and detail as the commission prescribes all tabulations, computations, and all other information required by it to carry into effect any of the provisions of this part, and shall make specific answers to all questions submitted by the commission. Every public utility receiving from the commission any blanks with directions to fill them shall answer fully and correctly each question propounded therein, and if it is unable to answer any question, it shall give a good and sufficient reason for such failure." PG&E failed to provide a good and sufficient reason for such a failure in this circumstance.

Section 19 of the PSA requires all parties to "cooperate fully and in good faith to obtain timely confirmation of the Settlement Plan and to effectuate the transactions contemplated by this agreement and the Settlement Plan." (PSA, p. 24, § 19.) As for the SM #1, PG&E's response was received on August 13, 2003, five working days after the original data request was issued, however SM #1 required that "If proponents dispute the request, they should do so within three days of the request." (SM #1, p. 4, § 12.) This was not done.

In addition, ORA's discovery was hindered by key PG&E personnel being out of the office for extended period of time. PG&E's case coordinator, Cecilia Montana was out of the office from August 14, through August 22, 2003.

PG&E's lack of access made a reasonable review by ORA impossible. Therefore, ORA cannot validate any of the numbers included in the PSA. In order for ORA to properly evaluate the PSA, ORA will need to be given sufficient access to the supporting documents, and key personnel at PG&E to substantiate the basis for the PSA.

IV. CASH AVAILABLE

ORA's motivation for conducting a review of cash available is premised upon the amount appearing grossly understated. This concern is based on the combination of foregone dividends ($1.2 billion), 2001 and 2002 headroom ($3.89 billion), and 2003 headroom ($775 to $875 million) which totals $5.865 to $5.965 billion and sharply exceeds the PG&E calculated December 31, 2003 cash available forecast of $2.365 billion. ORA's review of the cash available forecast prompted a number of questions that were addressed by PG&E via a meeting and phone calls. However, despite ORA's contact with PG&E's representatives, general and specific concerns still exist and are as follows:

A. General Concerns

1. **Cash Available Forecast Was Prepared on an Overly Conservative Basis –** ORA considers cash forecasts to tend towards a conservative nature given the negative implications of an operating cash shortfall. Further, ORA believes, forecasting procedures appropriate for preparing a cash forecast related to ongoing operations does not entirely apply to a cash forecast prepared on the basis of a company emerging from bankruptcy. Thus, ORA is concerned the cash available forecast is understated due to the conservative approach utilized.

2. **Inability to Audit the Cash Available Forecast –** ORA is concerned the cash available forecast prepared by PG&E was subject to very little scrutiny. This concern is based on those parties participating in the drafting of the PSA having little reason to contest the forecast. If the needs of all parties privy to negotiating the terms of the PSA are met, and if the level of new debt is acceptable, to what degree of scrutiny was the cash available forecast subject? Further, ORA's concern that the cash available forecast was subject to little scrutiny is based on the largest contributor and what appears to be the most

underrepresented party (the ratepayer), being unable to participate in the negotiations.

3. **Lack of an Updated Cash Available Forecast** – Based on discussion with PG&E witness Walt Campbell, Director of Business and Financial Planning, the cash available forecast used in the PSA was prepared in late May, 2003 or Early June, 2003. To date, ORA is unaware of any updated forecast. ORA's concern is that given the relative size of Pacific Gas and Electric Company and given the importance of the PSA, an updated cash forecast that incorporates the actual results should have been prepared to assess the accuracy of the assumptions and methodologies used in preparing the initial forecast.

4. **"Plugging" to Meet a Desired Cash Available Forecast** – Upon review of PG&E's cash available forecasts, a use of cash of [redacted] was inserted for Funds held for [redacted], resulting in final cash available forecast at December 31, 2003 of [redacted]. However, in the final cash available forecast (utilized to determine PSA cash available), there was no mention of the need for the [redacted]. Instead, a different use of cash for $224 million was inserted ("plugged") relating post petition holding company costs and PG&E environmental enhancement corporation yielding a cash available forecast at December 31, 2003 of $2.365 billion. ORA understands that during the forecasting process mistakes occur and that all forecasts are inherently inaccurate. However, it is odd that one number was pulled out and then another of a comparable amount was inserted ("plugged"). How did PG&E initially make the mistake of erroneously including a deduction to cash for [redacted]; then, find a comparable amount that it initially missed? This oddity coupled with PG&E's noted lack of disclosure, lack of access, and lack of cooperation creates suspicion and causes ORA to question the accuracy and legitimacy of the cash available forecast.

5. **Excessive Spending to Meet Cash Available Projections** – Departments may potentially spend to levels projected, ignoring proper prudence as to the relative need of the goods and services purchased. If a bar for spending is set and this bar is not contested, it is ORA's concern that despite the necessity, PG&E will spend to this level to validate their estimate.

B. Specific Concerns:

Summary

Description	Amount of Concern (Dollars in millions)
Elimination of the Holding Company Costs	$217
Elimination of the Restricted Cash Requirement	$250
Overestimation of Capital Expenditures	$120
Elimination of the Outstanding Checks provision	$100
Total Concern	$687

1. **Improper Inclusion of Holding Company Costs –** Based on discussion with PG&E witness Walt Campbell, Director of Business and Financial Planning, these $217 million of incurred costs are bankruptcy related. Pursuant to the terms of the PSA, ORA noted that PG&E shall not recover any portion of the amounts so paid or reimbursed to PG&E Corporation in retail rates; rather such costs shall be borne solely by shareholder's through a reduction in retained earnings. Thus, ORA's concern is that these costs should not be borne by the ratepayer but rather the shareholder's of PG&E Corporation.

2. **Improper Inclusion of Restricted Cash** - Based on discussion with PG&E witness Walt Campbell, Director of Business and Financial Planning, and Diane Duran, PG&E Senior Financial Analyst, ORA understood the $250 million restricted cash is for purchases of fuel and energy as a condition due to the bankruptcy. ORA does not consider this deduction as an actual use of cash, but a form of security that provides reassurance to the suppliers that sufficient cash is available given PG&E's current financial situation. Further, ORA considers expenditures for energy and fuel have already been accounted for as cash disbursements within the cash forecast's purchased power and gas disbursements section; and consequently, inclusion of this deduction would be double-counting. ORA's concern is also based on once PG&E emerges from bankruptcy that it will have cash on hand that can be restricted in a similar manner; and, that the need for restricted cash is temporary and may not be necessary once PG&E reaches "financial health". Thus, ORA is concerned that restricted cash as deduction to available cash is not appropriate as it is not an actual use of cash, expenditures related to the reason for its restriction have been accounted for under operations, and the cash restriction may be of a temporary nature.

3. **Overestimation of Capital Expenditures –** As of June 30, 2003, the Utility's capital expenditures for the 1st half of 2003 were $730 million yielding annualized expenditures of $1.46 billion. This is $192 million less than the

$1.652 billion annualized estimate per the cash available forecast. ORA assumes a portion of this difference may be made up in the 2nd half of the year; however, ORA's concern is that PG&E may spend to the level of the cash forecast. Further, ORA noted that capital expenditures for 2002 were $1.547 billion; whereby, the1st half expenditures were $745 million and the 2nd half expenditures were $802 million. As 1st half capital expenditures were roughly equivalent in 2002 and 2003, ORA in assuming a similar spending pattern would expect 2nd half 2003 expenditures to be roughly around $802 million. The actual $730 million and ORA estimated $802 million would result in estimated 2003 capital expenditures of $1.532 billion, or a difference of $120 million.

4. **Improper Inclusion of Outstanding Checks** – ORA assumes any check issued, even those issued on the last day of the year are for expenditures that have already been accounted for in the cash disbursements section of the forecast. Typically, outstanding checks are a subtractive item in reconciling the bank (cash) balance to book balance. However, as this is a "cash forecast", an adjustment of this type is not appropriate as ORA assumes expenditures in the normal course of operations have already been captured as disbursements in the operating section of the "cash available forecast". Thus, ORA is concerned the $100 million in outstanding checks is an improper reduction to cash available.

V. USES OF FUNDS

ORA calculates uses of funds that is $424 million lower than the PG&E Bankruptcy Proposed Settlement Plan Data Sheet. The Table 8-1 shows the basis for the breakdown.

Table 8-1

Uses of Funds

(Dollars in millions)

Projected Sources and Uses of Funds

Uses of Funds	***Settlement Plan in Millions***		***ORA***		***Difference***	
Estimated Allowed Claims	$	13,700	$	13,700	$	-
Claims paid during the bankruptcy case pursuant to Court orders and other adjustments	$	(1,564)	$	(1,988)	$	(424)
Total Uses of Funds	$	12,136	$	11,712	$	(424)

In response to an oral data request made by ORA, PG&E stated that it had paid $1,988 million to its creditors as of April 6, 2003 (Response to ORA Oral Data Request 1, question 2). Using this number instead of the number used in the PG&E Bankruptcy Proposed Settlement Plan Data Sheet results in $424 million in the uses of funds statement.

VI. RATEPAYERS CONTRIBUTION

ORA calculates ratepayer contributions that are $1,882 million higher than the PG&E Bankruptcy Proposed Settlement Plan Data Sheet. The Table 8-2 shows the basis for the breakdown.

Table 8-2

Estimated Ratepayer Contributions

(Dollars in millions)

Estimated Ratepayer Contribution

		Settlement Plan in Millions		*ORA*		*Difference*
2001 and 2002 Pre-Tax Headroom	$	3,200	$	3,894	$	694
2003 Pre-Tax Headroom		$775 to $875		$775 to $875	$	-
NPV of the Regulatory Asset	$	2,210	$	3,153	$	943
NPV of the Tax Component of the Regulatory Asset	$	944	$	1,189	$	245
Estimated Ratepayer Contribution		$7,129 to $7,229		$9,011 to 9,111	$	1,882

A. 2001 and 2002 Pre-Tax Headroom

ORA has reviewed copies of PG&E's monthly reports that show the balances in its TRA, TCBA, Must-Run Fossil Plant Memorandum Account ("MRFPMA"), Must-Run Hydroelectric/Geothermal Plant Memorandum Account ("MRHGPMA"), and Non-Must-Run Hydroelectric/Geothermal Plant Memorandum Account ("NMRHGPMA"). The difference between the 2001 beginning balance and 2002 ending balance of these accounts, excluding adjustments, present valued is $4,098 million. ORA's numbers exceed the PG&E Bankruptcy Proposed Settlement Plan Data Sheet by $922 million. ORA uses this number as it more accurately reflects PG&E's 2001 and 2002 Pre-Tax Headroom.

B. Regulatory Asset

ORA made two adjustments to the regulatory asset. The first adjustment corrects an error included in the PSA's calculation of return. The PG&E Bankruptcy Proposed Settlement Plan Data Sheet used a simple average in calculating the return. ORA used a model that reflects the uneven payment of the principal balance consistent with the mortgage method that was agreed to in the PSA. This increased the return on the model. The second adjustment is ORA used a different discount rate than PG&E. ORA's discount rate is discussed in chapter 2 of ORA's report. The difference between ORA and the number used in the PG&E Bankruptcy Proposed Settlement Plan Data Sheet is $1,178 million.

VII. SHAREHOLDERS CONTRIBUTIONS

ORA calculates shareholder contributions that are $315 million lower than the PG&E Bankruptcy Proposed Settlement Plan Data Sheet. The Table 8-3 shows the basis for the breakdown.

Table 8-3

Estimated Shareholder Contributions

(Dollars in millions)

Estimated Shareholder Contribution

	Settlement Plan in Millions		*ORA*		*Difference*	
Foregone Dividends	$	1,700	$	1,700	$	-
Conservation easements or donations to public agencies of 140,000 acres of watershed lands	$	300	$	-	$	(300)
Establishment of non-profit corporation dedicated to clean energy technologies	$	15	$	-	$	(15)
Estimated Shareholder Contribution	$	2,015	$	1,700	$	(315)

A. Foregone Dividends

ORA discusses and supports the amount of foregone dividends in chapter 2 of ORA's report.

B. Conservation Easements

ORA's removal of the Conservation easements is discussed and supported in chapter 6 of ORA's report.

C. Establishment of Non-profit Corporation

ORA's removal of the costs associated with the Establishment of a Non-profit Corporation is discussed and supported in chapter 6 of ORA's report.

VIII. REGULATORY ASSET

ORA calculate that the regulatory asset's cost is $145 million higher than the PG&E Bankruptcy Proposed Settlement Plan Data Sheet. The Table 8-4 shows the basis for the breakdown.

Table 8-4

Regulatory Asset Costs

(Dollars in millions)

Nomincal Cost of the Regulatory Asset

	Settlement Plan in Millions		***ORA***		***Difference***	
Regulatory Asset	$	2,210	$	2,210	$	-
Return Component Grossed up for taxes	$	1,537	$	1,682	$	145
Tax Component on Amortization	$	1,520	$	1,520	$	-
Nomincal Cost of the Regulatory Asset	$	5,267	$	5,412	$	145

A. Return Component

When the PSA calculated the return component for the regulatory asset, it used a simple average for the rate base component. Assets that use a mortgage style payback period have an uneven payback period, which shows a smaller payback of the principal at the beginning of the payback period, and a high payback of the principal at the end of the payback period. Using a mortgage style payback required that a higher average balance be used in calculating the return component. Correcting for this difference results in a $145 million higher return component than the PSA.

IX. CONCLUSIONS

Using the information that ORA was able to obtain, ORA determined that the costs of this plan have not been accurately identified. Ratepayer costs were under reported in the PSA while shareholder costs were over stated. In addition, virtually all of the risks have been allocated to ratepayers, and most of the benefits were given to shareholders. Ratepayers will have to pay for this plan for a minimum of nine years, while shareholder's required contributions stop on July 1, 2004.

APPENDIX A—GLOSSARY OF ACRONYMS & ABBREVIATIONS

Acronym	**Definition**
A.	Application
AL	Advice Letter
ATCP	Annual Transition Cost Proceeding
CDWR	California Department of Water Resources
CEQA	California Environmental Quality Act
CETC	Clean Energy Technology Commitment
CPCFA	California Pollution Control Financing Authority
CPUC	California Public Utilities Commission
Commission	California Public Utilities Commission
D.	Decision
DRC	Dedicated Rate Component
DWR	Department of Water Resources
Edison	Southern California Edison Company
GABA	Generation Asset Balancing Account
GMA	Generation Memorandum Accounts
HC	Holding Company
Moody's	Moody's Investor service
MRFPMA	Must-Run Fossil Plant Memorandum Account
MRHGPMA	Must-Run Hydroelectric/Geothermal Plant Memorandum Account
NMGHGPMA	Non-Must-Run Hydroelectric/Geothermal Plant Memorandum Account
NOL	Net Operating Loss
NPV	Net Present Value
ORA	Office of Ratepayer Advocates
p.	Page
pp.	Pages
PCB	Pollution Control Bonds
PG&E	Pacific Gas and Electric Company
PG&E EEC	PG&E Environmental Enhancement Corporation

Acronym	**Definition**
PROACT	Procurement Related Obligations Balancing Accounts
PSA	Proposed Settlement Agreement
PU Code	California Public Utilities Code
RARAM	Regulatory Asset Revenue Adjustment mechanism
RATBA	Regulatory Asset Tax Balancing Account
RD&D	Research, Development, and Demonstration
ROE	Return on Equity
RRBs	Rate Reduction Bonds
S&P	Standard and Poor’s Rating services
SCE	Southern California Edison Company
SM	Scoping Memorandum
TCBA	Transition Cost Balancing Account
TRA	Transition Revenue Account
TURN	The Utility Reform Network
USOA	Uniform System of Accounts
§	Section Number
¶	Paragraph

APPENDIX B—QUALIFICATIONS AND PREPARED TESTIMONY

QUALIFICATIONS AND PREPARED TESTIMONY

OF

MARK KENT BUMGARDNER, MBA, CPA

Q.1. Please state your name and address.

A.1. My name is Mark Kent Bumgardner. My business address is 505 Van Ness Avenue, San Francisco, California.

Q.2. By whom are you employed and in what capacity?

A.2. I am employed by the California Public Utilities Commission as a Public Utility Financial Examiner IV in the Office of Ratepayer Advocate's Energy Cost of Service Branch.

Q.3. Please briefly describe your educational background and work experience.

A.3. I have a Bachelor of Science degree in Business Administration (Accounting) and a Masters of Business Administration (Management Science) from California State University, Hayward. I am a Certified Public Accountant and I am a member of the American Institute of Certified Public Accountants. I am also a member of the International High IQ Society, Mensa, and the Cerebrals Society.

I joined the California Public Utilities Commission in 1981, and I have participated in General Rate Case proceedings on Pacific Bell Company, Roseville Telephone Company, Continental Telephone Company, Citizens Utility Company, San Diego Gas and Electric Company, and Southern California Edison Company. I have also participated on several special projects including the Southern California Edison Company/San Diego Gas and Electric Company merger, and being the project manager on Southern California Edison Company's Holding Company proceeding & review of Southern California Gas Company's new Headquarters.

Q.4 What is the purpose of your testimony?

A.4 I am sponsoring Chapter 7, Sections I, II, III, V, VI, and VII of ORA’s Report.

Q.5 Does that conclude your statement of qualifications?

A.5 Yes, at this time.

QUALIFICATIONS AND PREPARED TESTIMONY

OF

TRUMAN L. BURNS

Q.1 Please state your name and business address.

A.1 My name is Truman L. Burns. My business address is 505 Van Ness Avenue, San Francisco, California, 94102.

Q.2 By whom are you employed and in what capacity?

A.2 I am employed by the California Public Utilities Commission ("CPUC") in its Office of Ratepayer Advocates ("ORA") as a Public Utilities Regulatory Analyst V.

Q.3 Briefly describe your pertinent educational and professional experience.

A.3 I received a B.A. in Political Science and English and a M.A. in Political Science, State Politics and Policy Specialization, from the University of California, Davis. I received a J.D. from the University of San Francisco, and am a member of the California Bar. I joined the CPUC's Special Economics Projects Branch in 1986. During my employment with the CPUC, I have performed various tasks, and have spent most of my time on electric utility regulation. I have testified before the Commission related to PG&E's Diablo Canyon nuclear power plant (nuclear decommissioning trust funds, target capacity factor, long-term operating costs, utility retained generation capital and operating costs) Humboldt Bay Unit No. 3 nuclear power plant (decommissioning trust funds) and Southern California Edison's San Onofre Units 2 & 3 (utility retained generation capital and operating costs) and Unit 1 nuclear power plant (environmental costs and rate base recovery). I was also ORA project coordinator for PG&E's two rounds of fossil power plant divestiture and PG&E's efforts to market value its hydroelectric facilities. I also monitor energy-related legislative activities and occasionally testify before the Legislature representing ORA.

Q.4 What is the purpose of your testimony?

A.4 I am sponsoring Chapters 1, 5 and 6 of ORA’s Report.

Q.5 Does that conclude your statement of qualifications?

A.5 Yes, at this time.

QUALIFICATIONS AND PREPARED TESTIMONY

OF

JOE CABRERA

Q.1 Please state your name and address.

A.1 My name is Joe Cabrera. My business address is 505 Van Ness Avenue, 4th floor, San Francisco, California 94102.

Q.2 What is your position with the California Public Utilities Commission?

A.2 I am employed by the California Public Utilities Commission ("CPUC") as a Public Utilities Regulatory Analyst in the Energy Cost of Service Branch of the Office of Ratepayer Advocates (ORA).

Q.3 Will you please state briefly your educational background and work experience.

A.3 I am a graduate of California State University, Sacramento, with a Bachelor of Science degree in Accounting. I also hold a Master of Science degree in Taxation from Golden Gate University, San Francisco. Prior to the Commission, I worked for the Department of the Treasury, Internal Revenue Service, for 5-1/2 years as an Internal Revenue Agent, and in public accounting with a CPA firm.

I have been employed by the CPUC since October of 1985. From October 1985 through July of 1988, I participated in financial and compliance examinations as well as performed a variety of analysis and advisory work in the former Commission Advisory and Compliance Division.

From 1988 to 1992 I was a part time Lecturer of Accounting in the Department of Accounting, School of Business, at San Francisco State University. Prior to this I was an Adjunct Professor at National University in the Graduate School of Taxation.

I have been the ORA tax witness since August 1988. As the tax witness, I am responsible for federal and state income, and other tax estimates in general rate cases, advocating tax policy in other proceedings, as well as providing a variety of advisory work for other divisions within the Commission on matters related to regulatory tax policy. In addition to ratemaking tax policy, I have advocated ORA positions on a variety of issues such as qualifying facility contract administration, service quality, performance based ratemaking, emergency response standards, electric system reliability and public purpose programs.

Q.4. What are your areas of responsibility in this proceeding?

A.4 I am sponsoring Chapter 7, Income Tax Issues.

Q.5 Does that complete your prepared testimony?

A.5 Yes, it does.

QUALIFICATIONS AND PREPARED TESTIMONY

OF

CHRISTOPHER DANFORTH

Q.1. Please state your name and business address.

A.1. My name is Christopher Danforth. My business address is 505 Van Ness Avenue, San Francisco, CA 94102.

Q.2. By whom are you employed and in what capacity?

A.2. I am employed by the California Public Utilities Commission's Office of Ratepayer Advocates ("ORA") as a Program and Project Supervisor.

Q.3. Please describe your education and professional experience.

A.3. I have a B.A. degree in Mathematical and Computer Models in the Social Sciences (1972), and a B.S. degree in Information and Computer Science (1977), both from the University of California, Irvine. Additionally, I have an M.A. degree in Geography (1975), with specialty in urban and environmental planning, from the University of Toronto.

I joined the Commission in 1978. I became supervisor of the Marginal Cost and Analysis Section in 1986. I transferred to the Northern California Energy Cost Adjustment Clause Section of the Fuels Branch in 1992, to the Market Development Branch in 1997, and to my current position in the Electricity Resources and Pricing Branch in 2001.

Q.4. What is your responsibility in this proceeding?

A.4. I am sponsoring Chapter 4, "Maintaining Headroom Through 2004", of ORA's prepared testimony.

QUALIFICATIONS AND PREPARED TESTIMONY

OF

L. JAN REID

Q.1 Please state your name and business address.

A.1 My name is L. Jan Reid. My business address is 505 Van Ness Avenue, San Francisco, California, 94102.

Q.2 By whom are you employed and in what capacity?

A.2 I am employed by the California Public Utilities Commission ("CPUC") in its Office of Ratepayer Advocates ("ORA") as a Public Utilities Regulatory Analyst IV.

Q.3 Briefly describe your pertinent educational and professional experience.

A.3 I received a B.A. in Economics and an M.S. in Applied Economics and Finance from the University of California, Santa Cruz. I joined the CPUC's Utility Performance and Analysis Branch in 1998. During my employment with the CPUC: I have sponsored written testimony on the cost-of-capital, electric procurement, risk management, and credit ratings. I have testified before the Commission, made presentations in CPUC workshops, developed Econometric models, and provided internal financial and Economic analysis on cases related to market power, electric procurement, operations support services, asset valuation, PBR proposals, and service quality.

Q.4 What testimony are you sponsoring?

A.4 I am sponsoring Chapters 2 and 3.

Q.5 Does that conclude your testimony?

A.5 Yes.

QUALIFICATIONS AND PREPARED TESTIMONY

OF

MARK WATERWORTH, CPA

Q.1. Please state your name and address.

A.1. My name is Mark Waterworth. My business address is 505 Van Ness Avenue, San Francisco, California.

Q.2. By whom are you employed and in what capacity?

A.2. I am employed by the California Public Utilities Commission as a Public Utility Financial Examiner III in the Office of Ratepayer Advocate's Energy Cost of Service Branch.

Q.3. Please briefly describe your educational background and work experience.

A.3. I have a Bachelor's of Arts in Economics from the University California at Davis, a Bachelor's of Science in Business Administration with an emphasis in Accounting from the California State Polytechnic University, Pomona. I spent four years with the Accounting Firm of Deloitte & Touche, LLP, and 4 years with Genuity Inc., a telecommunications provider. I possess a California Certified Public Accountant's license.

Q.4 What is the purpose of your testimony?

A.4 I am sponsoring Chapter 7, Section IV of ORA's Report.

Q.5 Does that conclude your statement of qualifications?

A.5 Yes, at this time.